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Sovereign Wealth Funds and Domestic Investment in Resource-Rich Countries: Love Me, or Love Me Not?

Alan Gelb, Silvana Tordo, and Håvard Halland

"Innovation and best practices can be sown throughout an organization–but only when they fall on fertile ground."
Marcus Buckingham

Sovereign wealth funds (SWFs) represent a large and growing pool of savings. An increasing number of these funds are owned by natural resource–exporting countries and have a variety of objectives, including intergenerational equity and macroeconomic stabilization. Traditionally, these funds have invested in external assets, especially securities traded in major markets. But the persistent infrastructure financing gap in developing countries has motivated some governments to encourage their SWFs to invest domestically. Is it appropriate to use SWFs to finance long-term development needs? Does it matter whether such investments are domestic or foreign-held assets? This note considers these issues, particularly the controversial question of using SWFs to finance domestic projects, motivated partly by SWFs' perceived importance for development.

Largely Uncharted Territory

The relevance of SWFs in investment financing and market stability was underscored by the recent global financial crisis. Usually funded through excess foreign currency reserves, these funds have a variety of objectives and mandates, ranging from addressing the macroeconomic impact of revenue volatility in resource-rich countries to ensuring intergenerational equity, addressing future financial needs, and protecting a country's economy from extraordinary shifts in its fiscal situation.

SWF holdings traditionally focus on external assets, principally securities traded in major markets to respond to sterilization, stabilization, and risk/return objectives. Investment in infrastructure projects is not uncommon in SWFs portfolios with long-term investment horizons. But most SWF infrastructure portfolios focus on nondomestic, high-return existing infrastructure and low-risk, new, bankable infrastructure projects in Europe and Asia. The motivation for these investments has been mostly commercial (Balding 2008).

Yet, SWFs investing domestically are not as unusual as one might expect. According to Truman (2011), domestic holdings constituted 16 percent of total investments in a sample of 60 SWFs, although these included some pension funds, and Gelb, Tordo, and Halland (forthcoming) list 14 SWFs that invest domestically. But domestic infrastructure investment remains uncharted territory for most SWFs. In light of the pressing infrastructure needs, several resource-rich developing countries have established, or are in the process of establishing, SWFs with an expanded role as a national investor.

Angola, Mongolia, Nigeria, and Papua New Guinea are among the most recent examples of this apparent trend. Experts suggest that 20 SWFs are already mandated to invest

domestically (Monk 2013), and more are in the making, for example, Colombia, Morocco, Mozambique, Sierra Leone, Tanzania, Uganda, and Zambia. Many of the most recently created and planned SWFs with a domestic investment mandate are in resource-rich countries.

Why Are Governments in Resource-Rich Countries Looking at SWFs to Finance Domestic Infrastructure?

There appear to be a number of reasons why many governments wish to increase the role of SWFs in financing domestic infrastructure. One is the decrease in traditional sources of financing for infrastructure in developing countries since the recent global financial crisis. At the same time, infrastructure needs in these countries remain high, so popular sentiment may push the government to spend part of its accumulated financial wealth domestically. In addition, public investment in resource-rich countries often highlights significant management and governance challenges, including low capacity, weak governance and regulatory frameworks, and lack of coordination among public entities (Dabla-Norris et al. 2011). Against this backdrop, some governments may see the SWF as a means to improve the quality of public spending, and even to crowd in private investors to strengthen investment discipline.

The use of government revenue and export earnings from the ownership and taxation of natural resources presents a substantial macroeconomic and intertemporal challenge. This revenue may be partly saved in an SWF to provide benefits for future generations. It can be used to reduce public debt, smooth the effect of resource revenue volatility, or be spent on various government objectives. However, the ability of the economy to absorb spending delimits the size and efficiency of domestic investment by the government. To avoid waste and overheating of the economy, a large chunk of this revenue is typically invested externally.

Why Is Domestic Investment by an SWF a Tricky Proposition?

Recent macroeconomic studies suggest that domestic investment of excess reserves has the potential to raise economic growth and diversify the economy away from nonrenewable resources (Berg et al. 2012; Collier et al. 2009; van der Ploeg and Venables 2010). However, the use of SWFs to finance domestic infrastructure holds significant challenges.

Existing literature points to the difficulty of separating SWFs' domestic investment decisions from political interference and elite capture. As stated, transparent policy of investing on a commercial basis, with allowance for lower returns as a trade-off for public utility, is unlikely to eliminate such pressures: social returns are often difficult to measure, and domestic infrastructure investment in developing economies is not likely to offer the type of low-risk, high-return scenarios that characterize those infrastructure projects currently successful in attracting foreign SWF financing.

Furthermore, lack of government capacity for project selection, appraisal, design and implementation; weak governance and regulatory frameworks; and lack of coordination among government entities, as well as political economy issues, often compound the challenges faced by developing countries in planning and executing investment projects through traditional public expenditure channels, as well as in attracting private investors. Thus the question remains, would an SWF authorized to spend domestically be better suited to face these types of challenges?

Central issues are the relationship of SWF financing to the budget process and to procurement systems of sector ministries, as well as the establishment of appropriate benchmarks and safeguards to ensure the integrity of investment decisions. Depending on the size of domestic investment by the SWF, consistency with macroeconomic stabilization policies would likely be an issue: the SWF could exacerbate macroeconomic and asset-price cycles by investing heavily in domestic infrastructure when resource prices and the economy are booming.

The SWF could also be used to bypass parliamentary scrutiny of spending, resulting in inefficient and fragmented public investment programs. Adding the SWF to the list of entities authorized to invest domestically could compound the risks of wasteful expenditure, budget fragmentation, political capture, and lack of coordination with fiscal policy, especially in low-capacity and low-governance environments. By receiving its funds from excess reserves—instead of raising funds on financial markets as domestic development banks do—the SWF's operation would not be subject to similar market discipline. The volatility of excess reserves from extractives compared to the long-term nature of infrastructure project commitments, and the somewhat limited possibility of using real options to increase portfolio flexibility, may also affect the type of projects and investment mechanisms available to the SWF. However, although these risks cannot be eliminated, several measures exist to mitigate them.

What Institutional Measures Could Mitigate the Risks?

Competitive investments

Allocations for domestic investment should not be fixed at a certain portfolio share, but rather determined on the basis of competition with foreign assets. In periods of low domestic returns, or when there are indications of asset bubbles, investments would be channelled abroad. If the investment project has a clearly defined development objective, it would still be benchmarked against the financial return on foreign assets,

but allowances could be made for a limited mark-down from the benchmark rate, as discussed in greater detail below. Investments that do not abide by these criteria cannot be expected to yield a competitive return. This is, for example, the case of public schools, which should be financed by the national budget.

Pooled investments

Investing with private investors, pooling with other SWFs, and cofinancing with international financial institutions could be used by the SWF to reduce risk, bring in additional expertise, and enhance the credibility of the investment decision. The Nigeria Infrastructure Fund, having signed cooperation agreements with General Electric, the Africa Finance Corporation and the International Financial Corporation, exemplifies this approach (Rice and Blas 2013). Co-investing is standard practice used by institutional investors to manage risk, and crowd in strategic partners. Where there is a risk that investment decisions may be affected by political and lobbying pressure, limiting the role of the SWF to that of a minority investor can help to strengthen the integrity of the investment process. Taking advantage of its long-term horizon, the SWF could offer a range of instruments to share risk and make commercially attractive projects viable for the market. Through innovative public-private partnership arrangements, the SWF may accept a somewhat lower return on marginally commercial projects with large social benefits, thereby making the projects attractive for the private sector.

Strong corporate governance

Sound corporate governance is a prerequisite for effective and sustainable performance. It provides incentives for management to take actions that lead to the achievement of the shareholder's objective, and it facilitates performance monitoring by shareholders (Canada 2005). There is a large body of knowledge on effective external (relationship between the SWF and the state) and internal (composition and functioning of the board of directors or trustees and the SWF's management processes) governance arrangements.[1] The following aspects of governance are particularly relevant to SWFs authorized or mandated to invest domestically:

i. *Independent board.* Government officials often serve as board members for state-owned entities. Combining ownership and supervisory roles presents conflicts of interest that may undermine the integrity of both functions and expose decision making to political capture. To ensure an adequate level of professionalism and independence of the board (both actual and perceived), all board members should meet specific skills and experience requirements. Nomination committees comprising individuals deemed to be independent and objective can help ensure a politically independent selection process, although it is difficult to expect perfect independence when the owner is the state.
ii. *Professional staff.* To operate as an expert investor, the SWF needs to be staffed with well-trained professionals, just like any financial investor in the private sector.
iii. *Transparent reporting.* Consistent with good practice, SWFs permitted or mandated to invest domestically should issue publicly available reports covering their activities, assets, and returns. If the portfolio is partially market based and partially invested in projects with below-market returns, these should be reported separately.
iv. *Independent audit.* An internal audit should be reported directly to the board, while an external audit ought to be conducted by an internationally reputable firm that is independent of the state.

What Should the SWF Invest In and How?

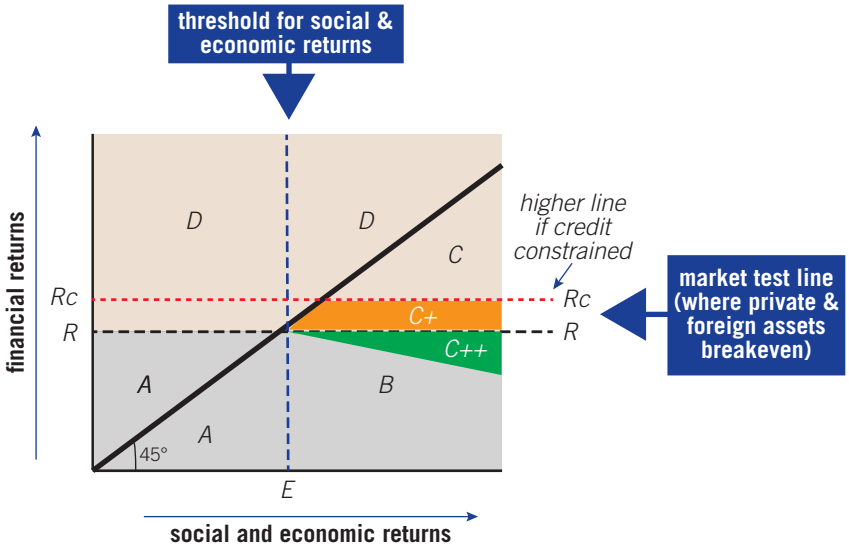
Projects are not created equal. Although a well-governed SWF with a sound mandate and professional management and staffing can possibly improve the quality of the public investment program, its mandate should not duplicate that of other financial institutions (for example, the budget or any domestic development bank). In other words, the scope of domestic SWF investments should be limited to those appropriate for a wealth fund.

Public investments can be evaluated from two perspectives: (i) their financial or private returns and (ii) their broader economic and social returns. The latter include positive or negative externalities for the wider economy and society that can cause the social rate of return to be higher or lower than the financial rate of return. For example, an infrastructure project might have positive economic or social externalities that are not fully captured by its financial return.

Figure 1 illustrates the universe of investment possibilities at the country level along two dimensions: the private and the social return.[2] Investments can be classified according to whether their financial returns pass a "market test," *R*. Those that pass lie in segments *C* and *D*, and will be attractive to private investors, including foreign SWFs; those that fail lie below. Figure 1 also shows whether the economic returns exceed an acceptable threshold, *E*. Those that fail this test are to the left of point *E*. The diagonal line separates investment opportunities that offer positive externalities (to the right) from those that provide only private benefits and that would not qualify for public investment.

Investments in segment *A* should never be undertaken, since they provide neither adequate financial or economic returns. Investments in segment *B* provide high social or economic returns, but low financial returns, such as rural roads, schools, or health facilities. These investments should be funded through the normal budget process. If the SWF's eligible investments should include this category of spending, any practical distinction between the fund and the budget would vanish, the SWF would lose accountability, and its vul-

Figure 1. Investments by Financial and Social/Economic Returns



Source: Authors' illustration.

nerability to political capture would increase. On the other hand, if an SWF were to invest in segments C or *D* according to purely commercial market principles, it could run the risk of simply displacing private investors.

To summarize, as a wealth fund, an SWF should not invest in projects that are justified primarily by their economic or social externalities. Such investments should be funded through the normal budget process, which should also make provision for the future recurrent costs necessary for operations and maintenance. SWF investment not warranted on commercial grounds would greatly complicate the accountability of the fund because its management could no longer be benchmarked on financial returns. The SWF also may not be accountable for the wider social and economic impacts of investments, which may depend on factors outside its control.

The SWF should therefore screen domestic investment proposals primarily according to their financial return and seek development opportunities with market or close-to-market financial returns in areas where it can crowd in, rather than displace, private investors. In some circumstances, the fund may accept a somewhat below-market return on domestic investments with large economic benefits. For SWF investments not fully justified on commercial grounds, it is essential to have a clear and transparent process for benchmarking financial returns and for trading off financial and nonfinancial goals.

Even if the theory is clear, its application is not without challenges. Identifying what constitutes an "acceptable quasi-market return" or "home bias" involves country-specific and project-specific considerations and poses the risk of reducing public accountability because the measurement of economic benefits is more ambiguous than that of financial returns. To this end, the capital objectives used by development banks and other financial institutions to ensure financial soundness of investments with a developmental purpose provide interesting examples. These include (i) achieving a minimal return that exceeds inflation (Financiera Rural of Mexico and Credit Bank of Turkey), (ii) generating a rate of return that equals or exceeds the government's long-term borrowing costs (Business Development Bank of Canada), and (iii) an explicit target return on capital, ranging from 7 to 11 percent annually (Development Bank of Samoa, EXIM Bank of India, and Kommunalbanken of Norway). The International Finance Corporation has developed a new financial valuation tool, the Sustainability Program Quality Framework, which attempts to capture the full value of sustainability/social programs. The tool, which is an attempt to remove the subjectivity of ratings, is currently being piloted.

While this methodology holds promise for SWFs, a possible alternative approach could be for the government to set the overall target return on investment for the SWF's portfolio and the threshold minimum rate of return for all investments (for example, the government's average long-term real borrowing rate on commercial loans). The SWF would then be free to decide on the composition of its investment portfolio to maximize the overall rate of return, while guarding against investing in a project with expected negative returns. For clear accountability, it is also important to separate the below-market portion from the market-based portfolio.

Conclusion

Though not entirely new, SWFs permitted or mandated to invest domestically are emerging on a wider scale. However, they have not been systematically assessed, therefore there is much to learn about their processes and activities. More research is needed to better understand their operations and potential role for financing in developing countries.

Since SWFs permitted or mandated to invest domestically combine features of traditional SWFs and development banks, they can draw on good practice examples from both types of institutions. Establishing rules on the type (for example, commercial and/or quasi-commercial investment) and modalities (for example, no controlling stakes, leveraging private investment) is one way to ensure separation between the activities of the SWF and those of other government institutions with investment mandates, such as the budget, the national development bank, the investment authority, and state-owned enterprises. The critical issue remains that of limiting the SWF's investment scope to those

appropriate for a wealth fund. If investments that generate quasi-market returns are permitted, the size of the home bias should be clearly stipulated and these investments should be reported separately.

The overall objective is to create a system of checks and balances to help ensure that the SWF does not undermine macroeconomic management or become a vehicle for politically driven "investments." The difficult environments in which some SWFs are being established suggest that these will often be major concerns. Only if the SWF is allowed to operate as a professional expert investor can it strengthen the management of the public investment program and contribute to building national wealth.

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About the Authors

Alan Gelb is a *Senior Fellow* at the *Center of Global Development* in Washington, DC. *Silvana Tordo* is *Lead Energy Economist* for the *Sustainable Energy Department, Extractive Industries*. *Håvard Halland* is a *Natural Resource Economist* for the *Poverty Reduction and Economic Management (PREM) Network* of the *World Bank*.

Notes

1. These include the *Santiago Principles for the Operations of SWFs* (IWG 2008), the *Revised Guidelines for Foreign Exchange Reserve Management* (IMF 2013), as well as general principles of good corporate governance practice, such as the *Principles of Corporate Governance* (OECD 2004) and the *Guidelines on Corporate Governance of State-Owned Enterprises* (OECD 2006).
2. This figure is not meant to represent the strategic asset allocation model of a single entity.

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