GROWTH AND CRISIS

Sovereign Wealth Funds Are Coming Home

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Followers of this blog have read several recent pieces on the changing landscape of investment finance in developing countries, particularly in natural resource-rich countries. We have approached the rise of development banks partially filling the void left by the retrenchment of international banking. We have also highlighted how less tax avoidance on extractive industries can be obtained and how that would make a huge difference in terms of resources available for local investment in those countries, provided that appropriate policies are put into place. Furthermore, we have pointed out the emergence of new forms and contracts of resource-backed investment finance, including a redirection toward home in asset acquisition made by developing countries' Sovereign Wealth Funds.

I have invited three colleagues who have been studying the subject more closely to write the short piece below. Hope you will enjoy it as much as I did.

Sovereign Wealth Funds Investing at Home: Opportunity Fraught with Risks
Håvard Halland, Alan Gelb, Silvana Tordo

Traditionally, economists have advised countries where oil, gas or mineral reserves are discovered to invest extractives revenues abroad, ensuring a continuous future revenue stream from the return on accumulated foreign assets. The structure to do this became known as a Sovereign Wealth Fund (SWF). More recently, it has become accepted policy for resource-rich developing countries to invest a larger share of resource revenues at home, through the national budget. Now, some of these countries are turning the concept of the SWF on its head by using SWFs directly for national investment, particularly in infrastructure. For many public finance experts, such intentions cause warning lights to flash, and for good reason - the risks are substantial. As several countries push ahead with this new role for SWFs, what can be done to minimize the risks, and could there be potential advantages? A recent Economic Premise by Gelb, Tordo and Halland addresses these important questions.

The Evolving Agenda of Sovereign Wealth Fund Policy

SWFs have become so common that it is easy to forget that the term has been in use for less than a decade. However, there has already been a paradigmatic shift in the way SWFs are expected to be used for development. Until three or four years ago, oil and mineral producing countries were advised to save resource revenues abroad according to some version of the permanent income hypothesis, which posits accumulation of foreign savings until returns on accumulated capital are sufficient to provide an even future revenue stream. For many developing countries, this always seemed like an outrageous idea, given urgent needs to expand infrastructure investment at home. Eventually, economists arrived at the same conclusion, considering domestic investments a potentially beneficial complement to foreign savings in cases where they contribute to increased economic productivity. For example, a new power plant can provide reliable access to electricity where power cuts previously hampered firms' output.

SWFs that Invest at Home

Several recent and upcoming oil and mineral producing countries, such as Tanzania, Uganda, Mozambique, and Sierra Leone, as well as Zambia, are now considering the use of their SWFs for direct domestic investment, outside of the national budget. In fact, this role for SWFs is not as new as it sounds, and Gelb and others (forthcoming) count fourteen SWFs that invest domestically, including well-established funds such as Singapore's Temasek and New Zealand's Superannuation Fund. These two funds, and several others, are commercial investors on par with pension funds and other privately owned funds, where the composition of the domestic investment portfolio is determined on the basis of expected financial returns. For other SWFs, including Malaysia's Kazanah, several funds in the Gulf States, and more recently the Nigeria Infrastructure Fund, the investment mandate goes beyond financial returns to include development objectives.

Why Resource Revenues Might be Safer Abroad

Using SWFs for national development purposes carries significant risks. From a macroeconomic perspective, there is the risk of exacerbating damaging boom-bust spending cycles. On the investment side, quality, productivity and integrity of investments may suffer, particularly in contexts where there is a high risk of investment decisions being affected by political and lobbying pressure, and the risk of low-productivity, badly selected and poorly implemented "white elephant" projects is high.

It could be argued that, in the light of such risks, SWFs investing domestically should make domestic investments based purely on financial returns. However, equity markets in developing countries tend to be underdeveloped, and new infrastructure projects are frequently considered too risky to be bankable on purely commercial terms. Under such circumstances, SWFs' opportunities for domestic investment could be very limited, and their contribution to development marginal.

Addressing the Risks of Domestic Investment

How can the integrity of SWF's investment processes be ensured, reducing opportunities for corruption and politicization while bringing additional expertise to the investment process? In their forthcoming piece, Gelb, Tordo and Halland propose three main avenues to address such challenges.

Firstly, they suggest that domestic investment projects should compete for funding with foreign assets, rather than be fixed at a certain portfolio share. 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 allowance could be made for a limited mark-down from the benchmark rate. Determining an acceptable "home bias" of this kind is challenging, and there are few examples to draw on. Gelb, Tordo and Halland discuss this issue in a forthcoming paper and suggest possible solutions. Investments that cannot be expected to yield a competitive return, such as for example public schools, would be undertaken through the national budget.

Secondly, partnering with experienced international investors can strengthen the integrity of the investment process and the quality of investments, by bringing additional oversight and expertise. The Nigeria Infrastructure Fund provides an example of this, having signed cooperation agreements with General Electric, the Africa Finance Corporation and the International Financial Corporation.
Third, SWF governance structures must ensure that investment decisions will be made independently of political and other pressures. Operational independence of professional management from the Board needs to be solidly embedded in the SWF governance structure, as well as an arms-length relationship between Board and the government as owner of the SWF. Additionally, if the SWF is large relative to the rest of the economy, coordination with overall macroeconomic policy is needed to avoid exacerbating macroeconomic cycles. Coherence with investments funded through the budget needs to be ensured by coordinating with the overall national investment program.

Looking for the Upside: Potential Opportunities and Advantages

The use of SWFs for domestic investments carries significant risks. But can there be an upside too? An SWF that invests domestically on a commercial or quasi-commercial basis could act as an expert investor that shares risk and crowds in private investment to projects that would otherwise not be bankable but have an important development impact. Where necessary the SWF could boost its capacity by involving foreign majority investors. The first paradigmatic shift in developing countries' resource revenue policy changed the emphasis from a focus on foreign savings to include a larger share of domestic investments. The next shift may see an expanded role for SWFs as active domestic investors. However, the risks are high, and the level of success will depend on the establishment of strong checks, balances and governance structures.

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