Macroeconomic and Financial Management Institute of Eastern and Southern Africa

Investec Asset Management

Report on the 2015 MEFMI Region Governors' Forum

Theme: Leveraging Sovereign Wealth Funds as a Tool for Economic Stabilisation

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TABLE OF CONTENTS

LIST OF ACRONYMS

AfDB	African Development Bank
BIS	Bank for International Settlements
BOP	Balance of Payments
DMP	Debt Management Programme
EAC	East African Community
FSM	Financial Sector Management Programme
GDP	Gross Domestic Product
IMF	International Monetary Fund
MDGs.	Millennium Development Goals
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
MMP	Macroeconomic Management Programme
MOU	Memorandum of Understanding
RAMP	Reserves Advisory Management Programme
SADC	South African Development Community
SSA	Sub Sahara Africa
SWFs	Sovereign Wealth Funds

FOREWORD

The re-introduction of the MEFMI Region Central Bank Governors' Forum on the calendar of MEFMI activities was motivated by the compelling need for the Central Bank Governors to share experiences on emerging risks and opportunities on the regional and international arena. The Forum provides an opportunity for the exchange of views, amongst peers and subject area experts. The 2015 Forum was held on the eve of the Bank for International Settlements Annual Meetings in Basel, Switzerland.

The theme of the 2015 Forum, ***"Leveraging Sovereign Wealth Funds as a Tool for Economic Stabilisation",*** was consistent with recent developments in the MEFMI region where first time producers of oil and gas are expected in the medium term while other member countries including Angola, Botswana, Lesotho, Namibia, Zambia and Zimbabwe generate substantial export revenue from natural resources extraction. Revenue from natural resources has significant impact on economic structures and outcomes particularly on monetary and fiscal policies, in which MEFMI has a keen interest. In fact, going forward, there are signs that the region is poised to become the world's new resource-based growth and economic frontier.

The most fundamental issue is, however, how natural resource rich countries in the region can effectively translate exhaustible resource wealth into sustained economic growth for poverty reduction. Africa has a lot to account for from past mistakes of having plenty of natural resource wealth but with huge infrastructure needs and a sizable number of its people remaining in abject poverty.

It is, therefore, hoped that going forward, the MEFMI region will be able to leverage its resources for economic transformation. This calls for the creation of the right institutions and conditions for transformation including significant investments in infrastructure particularly roads and railways, energy and ICT which are currently in deficit. In addition, there is need to ensure that a fair share of the proceeds and value from natural resources accrue to society to address and make a lasting impact on the socio-economic inequalities that countries continue to grapple with. This can only be possible with the introduction of efficient public finance management systems and institutions including Sovereign Wealth Funds (SWFs), which have become important vehicles for both intergenerational wealth transfers and instruments for economic stabilization in resource rich countries.

The good news is that there are encouraging signs that Africa is beginning to make a sizable dent on poverty through economic diversification into non-traditional service sectors and redirecting a huge portion of resources for inclusive and equitable growth. This is reflected in the current strong economic performance, even at a time when commodity prices have slumped.

This report provides presentations and discussions from the MEFMI 2015 Governors' Forum and it is our sincere hope that the deliberations and recommendations will provide valuable input not only to the debate but also to policy formulation and implementation in the MEFMI region.

A follow up on these recommendations will be made during the MEFMI Combined Forum in Lima, Peru in October 2015 where the highlights of this report will be shared with Principal Secretaries and Ministers of Finance and Planning and Central Bank Governors. The Institute welcomes comments to assist in further refining documented lessons to ensure that they remain suitable and applicable to the region[1].

Lastly, the Institute conveys its sincere gratitude to all the financial and technical partners that contributed in different ways to the success of the 2015 Governors' Forum.

Caleb M. Fundanga
Executive Director, MEFMI

[1]The views and recommendations reflected in this report are those of the delegates who participated in the Forum and do not necessarily reflect the position of the countries cited.

1. EXECUTIVE SUMMARY

The MEFMI Region Central Bank Governors' Forum was held in Basel, Switzerland, on 27 June 2015. Investec Asset Management was the financial and technical partner.

Given the volatile commodity prices, sovereign wealth funds have been identified and used in some countries as instruments of economic stabilisation. Therefore, the theme for the Forum was "Leveraging Sovereign Wealth Funds as a Tool for Economic Stabilisation". The event was attended by 38 officials, 13 of whom were Central Bank Governors and Deputy Governors with four from non-MEFMI countries. The Forum focused mainly on why the MEFMI region should support the establishment and strengthening of Sovereign Wealth Funds (SWFs) while also answering the question of how countries should apply natural resources revenue to achieve economic transformation.

The choice of this topic is in line with recent developments in the MEFMI region where many countries generate substantial export revenue from natural resources extraction while other countries are gearing towards tapping into the newly found oil and gas.

According to the MEFMI Executive Director, Dr. Caleb Fundanga, while the MEFMI region is richly endowed with natural resources, resource abundance is not permanent and therefore it is incumbent upon the region to contribute towards the prudent management of revenue from natural resources, and fully exploit the potential to contribute to economic transformation.

The slump in international commodity prices currently being witnessed provides an opportunity for countries to start laying the foundation for the establishment and management of SWFs and prepare to take advantage of the expected rise in commodity prices and resultant boom which business cycles predict as inevitable. Strong fiscal rules need to be established before earnings are received from the SWFs to avoid discretionary spending.

Countries in the region have competing priorities and are faced with the dilemma of what, where, when and how much to invest using the available resources. With huge infrastructure gaps and investment needs, countries are hard pressed to apply resources to achieve this development agenda and in numerous cases achieve industrialisation while also saving for future generations and stabilising budget.

Two presentations were delivered at the Forum to set the stage for discussions. These were on (i) Why the Recent Slump in Commodity Prices Strengthens the Case for African SWFs, Fiscal Rules and Good Governance, and

(ii) The role of Central Banks in managing a country's natural resource revenue: investment and institutional considerations.

There was consensus that saving revenue from exhaustible resources in SWFs for stabilisation and for future generations was critical among other objectives. The need to establish the main objective of the SWFs is critical as countries will need to determine how much revenue from the resources will be for savings, for stabilisation and for infrastructure development/investment purposes. The importance of citizen and political consensus in a country to generate buy-in is also critical.

Once those decisions are reached, the next important consideration is the institutional and legal arrangements. This should include clear segregation of duties between the principal and the agent. This includes the clear roles of Central Banks and external fund managers on one hand and the principal which is the Ministry of Finance and Parliament on the other.

It was recognised that Central Banks have the advantage of accumulated experience, firstly being independent institutions from government, secondly, with technical capacity, and thirdly, having a predominant culture of capital preservation in the investment decisions. This corporate culture plays quite a significant role where Central Banks tend to manage assets more conservatively than other entities when given the leeway to generate long-term return.

The Forum addressed these critical policy issues drawing from global experiences including the success model of Botswana.

It was underscored that the legal framework must make provisions for immunity and autonomy to agents in the management of natural resources which provide the safeguards against political patronage, interference and attachment

The need for explicit rules to be enshrined into law to govern drawdown of revenue from the fund was also emphasised.

It was also underscored that human resources policies must be strengthened to allow for attraction and retention of skilled staff in SWFs.

The Forum concluded that sovereign wealth funds are critical in the management of natural resources receipts as they are generally well managed even in countries where governance remains a challenge. In this regard, African governments should not regard the current slump in commodity prices as a reason to abandon their SWFs (or their plans to create such funds) – rather it is a timely warning of exactly why such funds are needed.

However, it was agreed that there is no straight jacket solution that is applicable to all. Africa will have to take a hybrid structure of governance and institutional arrangement which is applicable to unique country settings.

This report is organised as follows: Section 2 covers the Welcome and Opening session while Section 3 provides Forum Presentations and Discussions. The other sections provide the Side Interviews, Vote of Thanks, Luncheon, Lessons and Policy Recommendations.

2. WELCOME AND OPENING SESSION

2.1 Brief by Master of Ceremonies, MEFMI Director, Debt Management Programme, Mr. Raphael Otieno

The master of ceremonies for the Forum, Mr. Raphael Otieno, Director, Debt Management Programme at MEFMI welcomed and acknowledged all guests. Mr. Otieno thanked Investec Asset Management who agreed to join MEFMI in reviving the MEFMI Region Central Bank Governors' Forum.

Mr. Otieno noted that MEFMI was looking forward to very lively discussions as the Governors shared their experiences on how countries could use SWFs for economic stabilisation in order to support the development efforts in Africa

2.2 Welcome Remarks by MEFMI Executive Director, Dr. Caleb. M Fundanga

Dr. Fundanga, acknowleged all the stakeholders and welcomed all the delegates to the 2015 MEFMI Region Governors' Forum which was being held for the first time since 2005. He noted that the main objective of the Governors' Forum was to provide a platform for Central Bank Governors to discuss issues pertaining to economic policy management in the MEFMI region and relate them to global developments. He further noted that the Forum focuses on institutional and organisation setting in which Central Banks pursue monetary and financial policies. The Forum also provides an opportunity to exchange views, amongst peers and subject area experts.

Dr. Fundanga pointed out that the re-introduction of the activity was informed by the compelling need for Central Bank Governors to share experiences on emerging risks and opportunities that characterise the regional and international arena.

Dr. Fundanga thanked the Governors and other distinguished delegates for accepting MEFMI's invitation to participate in the Forum. He informed the meeting that the event was hosted jointly by MEFMI and the Investment Institute of Investec Asset Management. Dr. Fundanga took the oportunity to recognise the special role that Investec played in ensuring the success of the event as a technical and financial partner. He also expressed his sincere appreciation to Investec for their continued support. He further noted that Investec was among MEFMI partners for the flagship Combined Forum and indicated that MEFMI considered Investec as one of its key private sector partners. He noted that the keen interest shown by Investec to support the Governors' Forum had strengthened MEFMI's resolve to re-introduce the event.

He also conveyed his sincere appreciation to the Bank for International Settlements (BIS) for their support, particularly for providing a conducive venue for hosting the Forum. He pointed out that MEFMI has a long-standing and cordial relationship with the BIS. With the revival of the Forum, he looked forward to an even stronger working relationship. He expressed his gratitude to the BIS General Manager, Mr. Jaime Caruana, who attended the Forum in spite of his busy schedule ahead of the BIS Annual meetings.

Similarly, Dr. Fundanga thanked the Reserves Advisory Management Programme (RAMP) of the World Bank Treasury for accepting to participate in the Forum.

Dr. Fundanga extended a special welcome to the speakers: Mr. Malan Rietveld, Director, Investec Investment Institute and Dr. Ekaterina Gratcheva, Lead Financial Officer, World Bank Treasury (RAMP).

Dr Fundanga pointed out that MEFMI was cognisant of the fact that resource abundance is not permanent. He stated that it is incumbent upon the region to prudently manage revenue from natural resources, because of the potential for contributing to economic transformation.

He noted that he had no doubt that if revenue from these resources is managed prudently, the region could propel to another level, becoming the world's new resource-based growth and economic frontier, in the medium to long-term.

He emphasised that the Central Bank Governors' Forum was the beginning of a long journey to improving the continent's economic prospects.

2.3 Remarks by Mr. Thabo Khojane, Managing Director, Africa Client Group, Investec Asset Management

In his statement, Mr. Thabo Khonjane, Managing Director, Africa Client Group, Investec Asset Management highlighted the economic problem of the resource curse or the paradox of plenty. He stated that countries and regions with an abundance of natural resources tend to have inferior development outcomes than countries with fewer resources. He pointed out that for a long time; African countries seemed to have suffered from this curse.

He noted that while Africa is home to a third of the platinum mineral reserves, a tenth of the global oil output and producer of two thirds of the world's diamonds, the abundant resources wealth in combination with price volatility had made for a lethal cocktail of stunted development.

He, however, underscored that in spite of Africa's phenomenal endowment, countries have often suffered and he pointed out that from 1965 to 1998, in Oil Producing and Exporting Countries (OPEC), GDP per capita fell on average by 1.3% per annum. At the same time, per capita income in other parts of the world was growing at about 2 % per annum.

Mr. Khojane noted with optimism that there were encouraging signs that Africa was beginning to break the curse. To him, this is supported by the fact that despite the fall in prices of copper by 40%, and a significant fall in the global prices of diamonds and oil, the economies in the Africa region had maintained strong growth momentum due to growing economic diversification. In spite of these falling commodity prices, there is no evidence of the boom and bust cycles that the African economies have become accustomed to. He noted that to the contrary, the World Bank estimates that growth in sub-Saharan Africa (SSA) in 2015 would be robust at approximately 5.1%.

Furthermore, he stated that the region is beginning to successfully diversify the economies. He gave an example of Nigeria, noting that despite oil accounting for 95% of exports in recent years, growth in Nigeria has actually come from telecommunications, construction and banking services. Similarly, a third of the revenue in Angola now comes from non-oil resources while in Botswana, mining as a share of GDP has been on the decline for the past decade.

He further pointed out that one of the key ways to ensure that countries continue on this path of diversification was for a decoupling of government spending and investment from resource revenue. A key question is, how do countries transform depleting natural resources into permanent wealth? He pointed out that the presentation by Mr. Malan Rietveld, Director, Investec Investment Institute would explain why Investec sees the current slump in commodity prices as an opportunity for Africa to continue its transformation.

He concluded his remarks by thanking the MEFMI Executive Director, Dr. Fundanga, for inviting Investec Asset Management to be part of the incredibly important capacity building initiative.

2.4 Key Note Address by Dr. Adelaide Matlanyane, Governor, Central Bank of Lesotho

The Governor of the Central Bank of Lesotho, Dr Adelaide Matlanyane made the key note address for the MEFMI Region Central Bank Governors' Forum.

In her remarks she congradulated MEFMI for re-launching the Forum as it was last held in 2005. She stated that by reviving the Governors' Forum the Institute was providing a platform to the region's Central Bank Governors to discuss pertinent and critical monetary policy issues that affect the economic growth of the MEFMI region. She pointed out that the theme and the discussion topics for the 2015 event were pertinent to the region as there are concerted efforts being made towards leveraging natural resources for economic transformation.

She also pointed that the theme was appropriate going by the global trends and the interest in the management of revenue generated from natural resources over the past years. She noted, that a number of MEFMI region member countries have a substantial portion of their export revenue and earnings coming from natural resources.

She stated that Africa has large quantities of barely harnessed and exploited natural resources with countries such as Angola, Nigeria, Egypt, Cameroon and many others being oil producers. She pointed out that the MEFMI region will have first time oil and gas producers mainly Kenya, Mozambique, Uganda and Tanzania. She also noted that mineral resources are abundant in the region including copper which is abundant in Zambia and the Katanga region in the Democratic Republic of Congo (DRC), diamonds in Botswana, Angola, Namibia as well as in Lesotho. Similarly, gold in Zimbabwe, South Africa and Swaziland form part of this story.

She posed the question of how the region can apply natural resources revenue to achieve economic transformation. She stated that it was unfortunate that in many instances the wealth is hoarded in opaque accounts while the cost of infrastructure projects is inflated. She further pointed out that MEFMI countries remain in deficit in terms of infrastructure development. In addition, some countries export raw commodities, leaving value addition to be done elsewhere which is where the benefits accrue. She noted that these and other similar practices have sustained great economic inequalities in resource rich countries, hence the term resource curse.

She indicated that these challenges extend beyond weak governance to include skewed ownership and distribution of wealth. She noted that in view of these mixed stories, she was pleased that MEFMI had organized the Governors' Forum, a platform she said was critical as it stimulated debate and sharing of experiences on how to leverage natural resources revenue towards transforming the economies in the MEFMI region.

She applauded Botswana, which is rich in diamonds and has experienced relatively stable and sustained high economic growth for decades. In addition, the country has managed to retain profits from processing its raw materials.

She challenged the delegates, stating that it is squarely upon countries to leverage the revenue from natural resources to transform economies. She highlighted the need to create the right conditions for such transformation, including investment in infrastructure, and education; creation of larger markets, having sound land management and balanced tax systems; and ensuring that a fair share of the proceeds and value from natural resources accrue to society.

She noted that the Forum would address two areas that are important for the transformation of natural resources, namely the rationale for SWFs as well as the related institutional considerations..

With regards to MEFMI's role of carrying out its capacity building mandate, she noted that the Institute collaborates with relevant stakeholders to achieve its institutional mandate. In this regard, she echoed and underscored the sentiments by the MEFMI Executive Director and commended Investec for their support. In a similar way, she recognized the support given by the World Bank through RAMP. She underscored the significance of strategic partnerships between MEFMI, Investec and World Bank. In addition, she acknowledged the key role that BIS played in ensuring the success of the event by providing state of the art venue and services on gratis basis.

3. FORUM PRESENTATIONS AND DISCUSSIONS

3.1 SESSION 1: WHY THE RECENT SLUMP IN COMMODITY PRICES STRENGTHENS THE CASE FOR AFRICAN SWFs, FISCAL RULES AND GOOD GOVERNANCE

This session was presented by Mr. Malan Rietveld[2] and moderated by MEFMI Director, Financial Sector Management Programme Mr. Patrick Mutimba.

3.1.1 OVERVIEW OF SWFS

Mr. Rietveld pointed out that over the last two decades SWFs have witnessed growth and proliferation of new funds in countries with natural resources particularly Asian countries with surplus foreign exchange reserves. He noted that it is difficult to get an accurate figure on the size of assets for SWFs because of lack of full disclosure but estimates are roughly at US$4 to US$ 6 trillion globally. He pointed out that the most striking issue in the global community of SWFs is the enormous economic, political and institutional diversity amongst countries with SWFs. Among the richest countries with SWFs are Norway, Canada and USA while Papua New Guinea and East Timor are among the poorest. It is therefore an institution that has been embraced by all countries in the full spectrum of economic development.

He noted that Africa is a new growth region for SWFs being home to a number of countries looking at new legislation to establish SWFs. He stated, that in order to study SWFs deeply, Investec engaged partners including the Belfer Centre for Science and International Affairs at the JFK School of Government and the Centre for International Development both at Harvard University. They worked with Professor Ricardo Hausmann, a former Minister for Economic Planning from

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[2]Mr Malan Rietveld is the Director of the Investec Investment Institute. His area of responsibility focuses on investment policies in the extractive industries, including resource-related infrastructure, foreign direct investment and the management of resource revenue. Previously, he worked in the Emerging Market Debt team at Investec Asset Management and was involved in the firm's advisory work with central banks and sovereign wealth funds. Malan holds an MSc in Economics from the University of Leuven and an MSc in Economic History from the London School of Economics. He is currently completing his PhD in Economics from the University of Stellenbosch on the topic of sovereign wealth funds. Malan is a Fellow at the Center for International Development at Harvard Kennedy School and a Fellow of the Columbia Center for Sustainable Investment at Columbia University.
The Harvard studies can be downloaded at http://www.investecassetmanagement.com/en/insight/investment-institute/managing-sovereign-wealth

Venezuela – an oil rich country which has gone through many of the challenges associated with abundant natural resources (resource curse) and Dr. Khalid Al Sweilem, who was the Director General of investments at the Saudi Arabian Monetary Agency for twenty-one (21) years.

The objective of the study was to define and classify the whole spectrum of sovereign investors, from Central Bank reserve managers to public pension funds in different types of SWFs. Further, it sought to bring out the different ways in which SWFs achieve policy objectives, support spending, stabilise volatile revenue and other volatile macroeconomic variables and the extent to which they are a vehicle for saving public revenue particularly for resource rich countries. In addition, the study sought to highlight governance and implementation issues, institutional arrangements that countries have embraced, and the pros and cons of all the different approaches which have been undertaken.

3.1.2 SWF PROFILES

The study looked at case studies of governance structures and organisational setups and policies of 15 leading SWFs in 12 different countries; and interviewed a range of policy makers, advisors, and academics that are subject area experts in SWFs.

The first report from the study profiled the 15 SWFs, using a consistent framework, looking at:

- The economic and political context, and articulation of the official mandates;
- Sources of funding and rules on which those funds are capitalised, their liabilities or spending rules; and
- The governance structures and broadly the investment style.

He reported that most of the SWFs studied are from resource rich countries, however, some are public related investors like the South African Public Investment Corporation (PIC) and the Chinese Investment Corporation.

3.1.3 SOVEREIGN INVESTOR MODELS

The second report covered several issues that emerged from the case studies including:

- The SWF universe, the distinguishing features of investors and SWFs, basic savings rules that countries could look to implement and distinguished between the basic rule of thumb measures that could be considered rudimentary and sub-optimal policies that are good as a starting point when trying to build up a fund;

- A fully-fledged, rule-based framework which co-integrates savings, stabilisation and spending decisions into a consistent framework;
- Thirdly, the study modelled the rule-based framework in a number of countries, looking at new producers like Ghana; and established producers with massive infrastructure needs like Nigeria and Saudi Arabia whose fund reached a level of US$850 billion before it adopted a formal rules- based framework; and
- The objective was to define the sovereign investor universe and extract or generate a model for resource based SWF.

The framework was applied to these three contrasting cases based on Ricardo Haussmann's work on resource rich jurisdictions like Albania, Colombia and Kazakhstan, and the implications of different combinations of spending, savings and stabilisation; and

- Finally the report highlighted governance and implementation issues.

The model worked on the hypothesis of four major groupings of sovereign investors:

- First, at the top, are SWFs which are organised according to the main sources of capital, main function and typical investment model;
- Secondly, are Central Banks;
- Public Pension Reserve Funds; and
- Finally a range of sovereign development institutions including sovereign development funds. For the purpose of the study, Investec differentiated these development oriented funds from the classical SWFs – savings and stabilisation funds, especially due to the massive infrastructure development needs/gaps in Africa.

The study found that most countries are still implementing a variation of the basic rule of thumb measure of savings: The simplest being to save a certain percentage of all resource revenue, for example, saving 20%, 30% or 50%. The advantage of this approach is that it is easy to communicate and understand, but the disadvantage is that it does not have a countercyclical mechanism since it does not provide for adjustments during times of booms and busts. Thus, this rule requires that a country consistently saves the prescribed percentage in both good and bad times.

In view of this, Mr. Rietveld highlighted two other rules of thumb that attempt to counter the cyclical savings rule.

i. The first is a deviation from a moving average, which attempts to provide a measure of stability of flow of assets to the fund – whereby a country takes a three (3) or four (4) year moving average of oil (resource) revenue and saves a percentage. This provides a more stable transfer and requires that in a time of a commodity price downturn a smaller proportion is saved.

ii. The second method has a reference price, thus the country takes a decision, either political or expert-driven, on the equilibrium oil (resource) price for the year. Thereafter, revenue that accrue when oil (resource) prices are above the stated equilibrium price are placed in a fund. When there are shortfalls, there could be withdrawals from the SWF. For example in the case where a country's budget is formed from a reference price of US$70 per barrel, while oil prices are US$60 for the year, the result is a net outflow from the fund and vice versa. He pointed out that this model has been implemented in the Nigerian fiscal framework.

iii. However, for the more established countries like Norway, the SWFs savings rule is tied to the fiscal framework. Norway contributes a fixed 4% return from the assets of the fund and this corresponds to the size of the non-resource deficit they can run. Thus they fund a deficit from a sustainable flow of funds from the SWF. Mr. Rietveld underscored that the rule, if prudently applied is good; however, it is difficult to apply in a country which is resource dependent like Nigeria, where oil revenue make up almost the entire budget revenue base.

Mr. Rietveld emphasised that there are shortcomings in all methodologies and sought to clarify the way forward for countries. He submitted that an integrated framework is the way forward, whereby a country considers spending, savings and stabilisation decisions together. To test this model, Investec built on Professor Haussmann's work and applied it in the resource rich countries of Albania, Azerbaijan, Columbia and Kazakhstan.

The model thus tries to identify a sustainable balance between spending, saving and stabilisation.

Mr. Rietveld argued that the integrated framework is really a fiscal rule outside the realm of influence of the central bank. However, he pointed out that in several countries, the central bank is the operational manager of the SWF and is also an important voice in the discussion around sustainable policies in the management of SWFs.

He highlighted that the framework is flexible in that it is possible to assume and model different resource scenarios, volatilities, and shocks to resources revenue. In addition, the model can have different return assumptions for the stabilisation and savings fund and different spending rates can be specified out of the fund. These can be applied to a country specific context and the implications of each determined.

Mr. Rietveld stressed that the ultimate objective, which resource rich and resource dependent countries should strive towards, is to achieve a decoupling of government spending from oil (resource) revenue from the underlying and volatile source.

He theorised that countries should work on the following assumptions: Instead of spending the revenue from natural resources from a particular year, a rule-based framework would decouple spending to three components:

i. First, consume a fixed percentage of the previous year's spending such as 50%, 70% or 80%. This is inherently stabilising. Consequently, if there is a revenue boom in a particular year, the hands of the country are tied not to overspend that revenue. Similarly, in a period of a shortfall, spending is still anchored by the *alpha parameter - transfers based on the previous year's spending*[3]*;* and

ii. To further stabilise spending, there is a transfer from the stabilisation fund which is a more long-term, illiquid portfolio; and

iii. Finally, a country receives a sustainable income from a long-term endowment fund or an investment/income fund.

3.1.4 THE CASE OF SAUDI ARABIA

Mr. Rietveld briefed delegates on the case of Saudi Arabia, the world's largest oil producer. He highlighted that between 2011 and 2013, the country generated between US$300 – US$350 billion in oil income annually. The country has numerous years of cheap to extract oil, whereby the modelled cost of extraction is approximately US$2 – US$4 a barrel. Consequently, irrespective of how low oil prices get, Saudi Arabia would most likely be the country with the cheapest oil extraction. In addition, they have approximately US$850 billion of previously accumulated foreign assets.

However, there are several emerging challenges. Saudi Arabia is oil dependent, with oil accounting for approximately 85% of export earnings and 90% of fiscal revenue and the dependence has been rising steadily since the 1970s. Consequently, there is a massive rise in volatility in revenue and long-term debt/GDP ratios are highly correlated to oil revenue as is government capital spending on infrastructure and other long-term projects.

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[3] $T_t = \alpha TS_{t-1} + \beta S_{t-1} + \delta E_{t-1}$

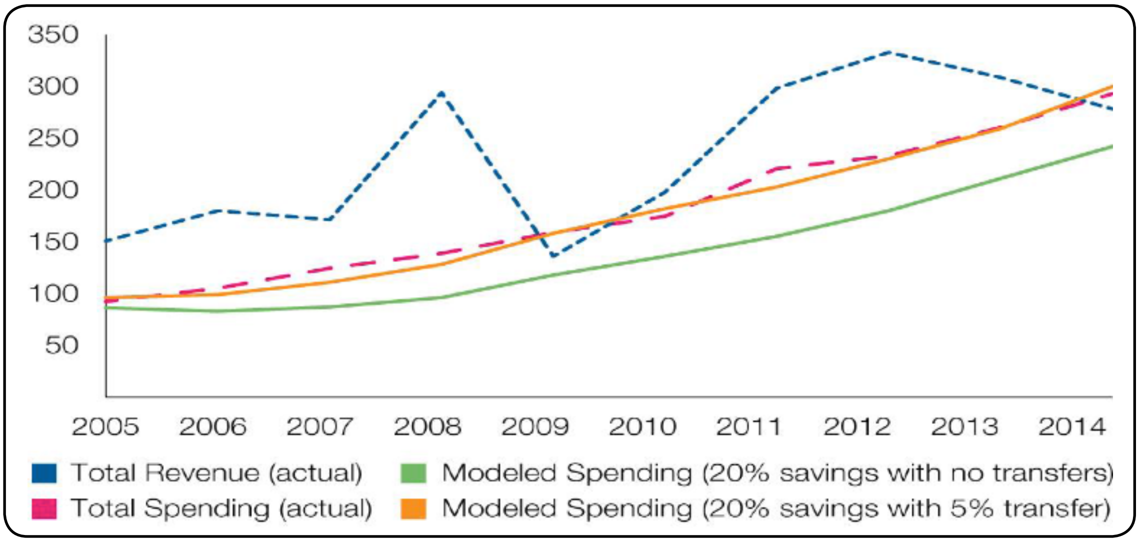
He further highlighted that the accumulated foreign assets of US$850 billion are at risk of depletion; from August 2014, Saudi Arabia utilised approximately US$150 billion, a situation driven by the breakeven price of oil which is required to balance the budget and which has been steadily increasing from US$65 to over US$100 per barrel. With oil prices at current levels (mid-60s), Saudi Arabia is drawing down on the reserves.

Another possible potential threat in the long-term is their market share in oil production given new producers. Thus, it is not clear if they will continue to enjoy the same revenue from oil. Furthermore, the Middle East demographics of an ageing population will put a strain on public finances in a couple of decades.

He noted that the main challenge with Saudi Arabia accumulation of assets was the ad hoc manner of application, where there were no rules and structures governing the flow of money in and out of the fund. This is largely a fiscal problem but it also creates a problem for the reserve manager who cannot plan due to the unknown nature of government funding requirements.

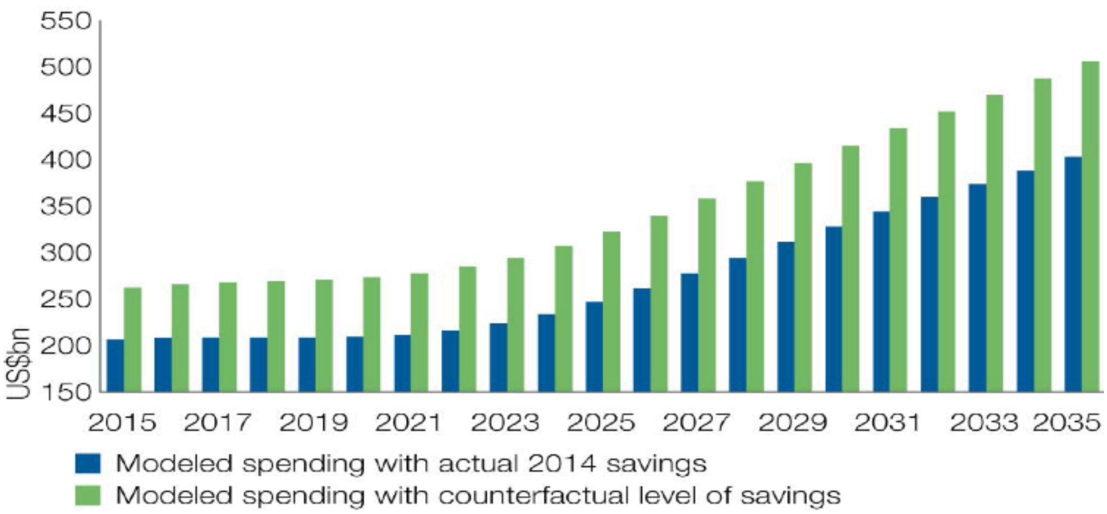
He pointed out that Investec sought to test the model developed to determine what the reserves would have looked like if Saudi Arabia had applied the model since 2005. They made several assumptions on distribution of existing reserves between the stabilisation and savings fund, taking the return from the savings fund based on the 60:40 rebalanced portfolio. Investec results were a close approximation between the actual total spending of Saudi Arabia given their current spending/savings versus a 20% savings with no transfer model and a 20% savings with a 5% transfer model as shown in Chart 1 below.

Chart 1 – Actual vs. Modeled Spending/Revenue



However, as Mr. Rietveld highlighted, the main difference was the actual savings as at end of 2014. Saudi Arabia had approximately peak assets of US$850 billion, while the model had approximately US$1.4 trillion of foreign assets. Saudi Arabia would have therefore achieved a better outcome if they had a more rule-based framework that allowed for spending in addition to larger earnings on long-term saving funds than was the case as shown in Chart 2 below.Chart 4 – Alpha, Gamma and Beta Transfers Based on Oil Revenues of 50%

Chart 2 - Actual vs. Modeled Spending/Savings



Investec also considered a scenario where the long-term funds were not providing additional funds to the budget, thus requiring a lower level of spending, but would still have allowed for significant spending over the period under review. In this scenario, they would have accumulated approximately US$1.85 trillion of foreign assets.

Investec also modelled a slump in earnings in view of the current economic climate and fall in oil prices, and a fix on spending, where Saudi Arabia needs to accumulate savings in their fund.

The results from that modelling highlighted that as the fund continues to accumulate, spending rises in a sustainable manner.

3.1.5 KEY POLICY LESSONS AND RECOMMENDATIONS FROM SAUDI ARABIA

i. Establishment of fiscal rules around resource management: Currently, the authority sits with the Ministry of Finance. However, it is recommended that the authority sits at the highest authority which is the Supreme Economic Council which is more broad-based and includes the Central Bank Governor;

ii. The cost of delayed reforms: Delays from the past decade have an opportunity cost which should be considered especially in the backdrop of the emerging challenges; and

iii. Organisational structure: The stabilisation fund should remain with the Central Bank. This recommendation is based on the assumption that the investment profile is similar to Central Bank Reserves Portfolio. The portfolio manager then reports to the Ministry of Finance to allow for planning based on expected revenue. The more long term fund providing a stable transfer, the future generations fund, should be managed by a separate entity given the scale of assets. The proposed governance structure would include the highest political authority which meets infrequently and an independently appointed technical board of directors and a senior executive team.

3.1.6 THE CASE OF AFRICA

In the case of Africa, Mr. Rietveld highlighted that in 2012 and 2013, it appeared that SWFs were growing, with governments searching for the right models. However, the collapse in commodity prices has raised questions on the viability of the African resource story and it is unclear if it is a temporary or permanent situation.

He argued that the current slump in commodity prices underscores the importance of SWFs which should be in place to stabilise volatile revenue, support domestic infrastructure development/investment which is a massive priority in Africa, and transform depleting volatile resources into a more stable permanent one. He stressed that like all other continents, Africa needs to balance between savings, spending and stabilisation decisions.

3.1.7 THE EXAMPLE OF GHANA

Mr. Rietveld noted that Investec looked at how the savings, spending and stabilisation decisions can support and sustain domestic investment, using the example of Ghana.

He pointed out that Ghana is a country that is expecting a significant but temporary boom in oil revenue and thus can act as an illustrative model for other countries facing a decade or two of sharp increase in oil revenue followed by depletion.

Based on the model, the alpha – *transfer based on previous year's spending*[4] *and beta – transfer based on size of stabilisation fund,* are stabilisation coefficients and can be modelled assuming different volatilities of oil revenue. The decision

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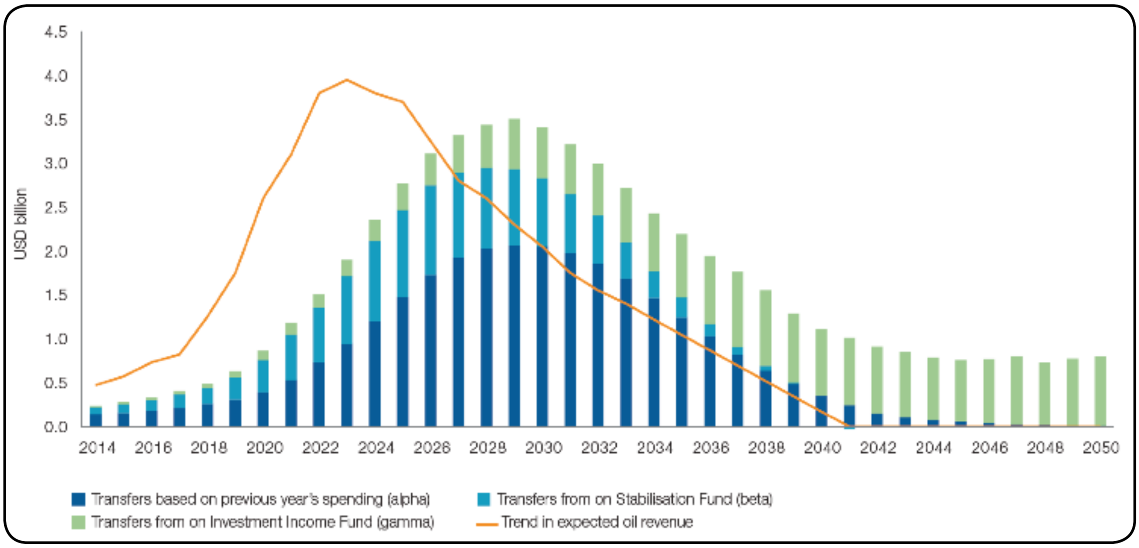
[4] $T_t = \alpha TS_{t-1} + \beta S_{t-1} + \delta E_{t-1}$

on the parameters needed from the alpha and beta to stabilise spending, given different assumptions on oil volatility is largely a technical decision.

The discretionary policy variable is the savings rate, which carries the preference of policy makers in terms of trading off current spending versus future income from the oil fund. In other words, it is the rate at which a depleting natural asset is transformed into a permanent financial asset. Mr. Rietveld explained that, based on the model, and using base estimates of Ghana's oil reserves, the 'trend in average expected oil revenue' is expected to increase sharply in the next few years and peak in about a decade and then gradually deplete. The path around this trend would be expected to be highly volatile depending on extraction and pricing issues. He pointed out that the model allowed for considerable volatility around the trend.

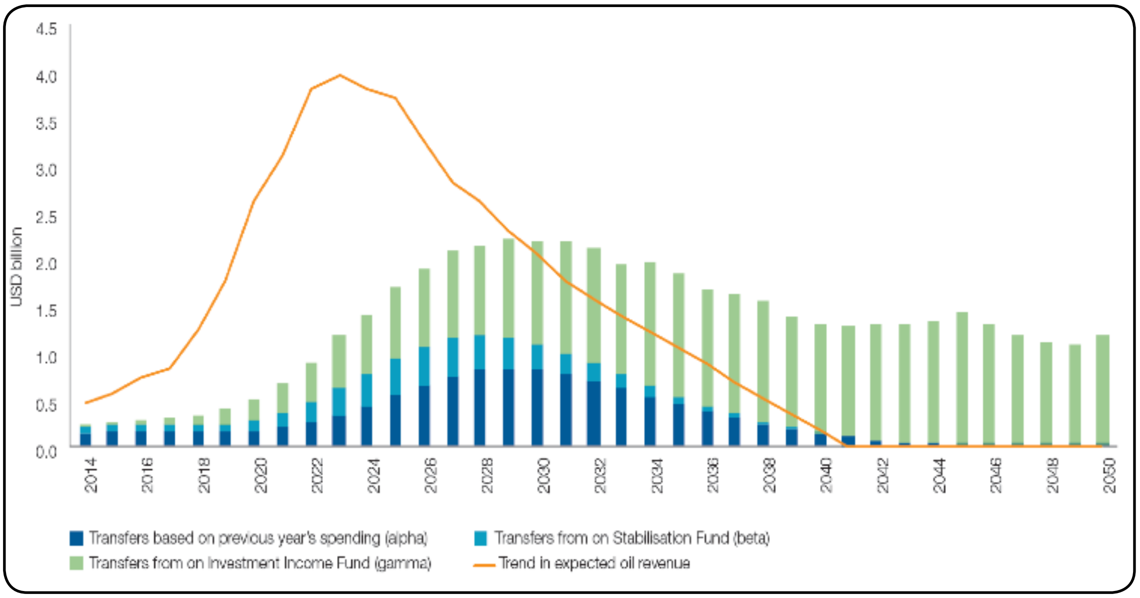
The model works with a fiscal framework with Ghana saving 25% of oil revenue. With this, long-term spending from oil, that is the gamma – transfers from an income investment fund, become the sole source of income as oil depletes and stabilises permanently at US$1 billion of income in real terms. In addition, it allows for a significant amount of spending roughly over the same period as the oil revenue arrives, the alpha – transfer based on previous year's spending and beta – transfer from stabilisation fund, as shown in chart 3 below.

Chart 3 – Alpha, Gamma and Beta Transfers Based on Oil Rrevenue of 25%



The other model case highlighted is Ghana saving 50% of oil revenue, a more conservative long-term outlook spending from oil, the gamma – *transfer from an income investment fund,* stabilises at US$1.5 billion of income in real terms as shown in Chart 4 below.

Chart 4 – Alpha, Gamma and Beta Transfers Based on Oil Revenue of 50%



Putting this into the context on saving versus spending on infrastructure, bearing in mind the US$2 – US$2.5 billion of spending from oil income, it should be noted that in the past five (5) years, Ghana has spent, in actual terms between US$1billion andUS$1.5 billion on infrastructure. Using the model, from the income earned using the conservative approach; Ghana would be able to double the spending on infrastructure based only on oil revenue and sustain it permanently.

In view of these scenarios, Mr. Rietveld underscored that there should not be a contrast and debate between savings, spending and stabilisation policies. The framework achieves not only a stabilisation of volatile oil revenue but creates a significant scale up in spending from oil revenue and a sustainable endowment to continue once the oil depletes.

Mr. Rietveld stressed that it is necessary to think of a savings policy even when domestic investment remains a priority. He explained this statement based on phenomena that the Norwegians call 'transforming oil to equities'. The earning power of capital (over a century) invested in different instruments - money markets, oil, bonds and equities. In the very long-term, there is a significant reward in investing in equities as transforming resource wealth to financial wealth has been rewarding. In addition, the Norwegians have calculated the Value at Risk (VaR) of the oil under the ground versus the assets in the SWF, and on a risk basis, they have found that the oil under the ground is exposed to considerably to volatility than a diversified SWF.

3.1.8 LESSONS FROM THE PRESENTATION

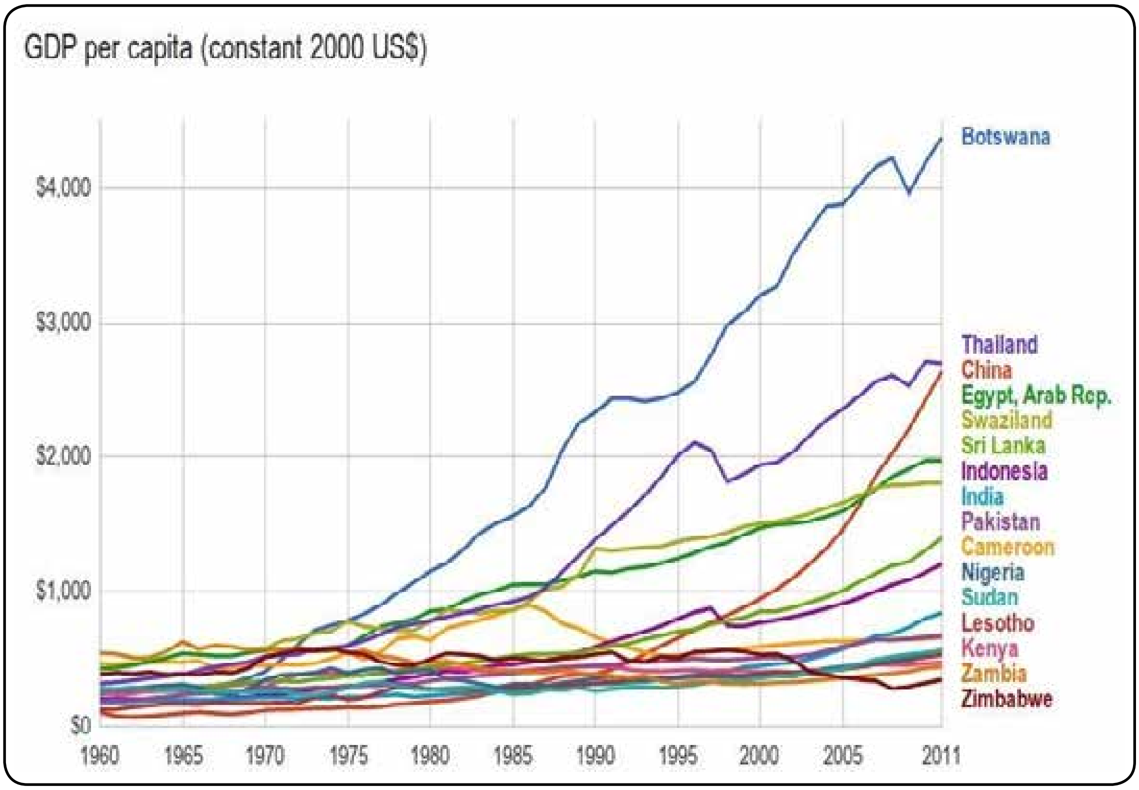
i. No one size fits all – this in itself is a challenge for policy makers trying to find the appropriate structure for African SWFs. It is important to note that the surveyed SWFs have significantly changed at present compared to inception and/or a decade ago. Their mandates and structures continue to evolve over time and are clarified and strengthened.

ii. SWFs are a work in progress - Investec is working with some of the most established funds – Middle East and East Asian SWFs and they are looking at ways to improve policy frameworks and governance structures, especially how to strengthen savings and spending policies in the current global climate of lower revenue and income from commodities.

iii. Transparency - a number of SWFs, prominently Norway and Chile, have consistently sought independent evaluation of what they do – by commissioning expert consultants from the investing arena, academic experts – to review their investment policies, their governance structures and submit these to parliament where they are discussed and actioned. Chile publishes the minutes of the committee that makes the recommendations regarding investments and spending decisions around their copper revenue.

iv. Management of SWFs - Botswana is a good example. From about 1960, the growth in per capita GDP has outperformed China, Indonesia, India, Thailand and several other economies in the world (Chart 5 below). This demonstrates how a fairly simple SWF model can be utilised and one which works in terms of the fiscal decisions coached in the medium and long term framework. In addition, the SWF contributes to the management of a volatile asset.

Chart 5 – GDP Per Capita 1960-2011



v. A SWF is a means to create stability and sustainability in the management of volatile oil (resource) revenue but not a panacea. The absence of appropriate rules can lead to pro-cyclicality in the spending of revenue. Rules can address some of the short-termism that permeates numerous countries with abundant resources.

vi. For Africa, the time is now to get house in order - In all the cases studied, it takes approximately a decade from the point of legislation initiation to when the SWF is capitalised. African countries have talked about this for two or three years, thus there are approximately seven to eight years to prepare the SWFs for the next oil (resource) boom.

vii. The African SWF model should involve a mix of savings, spending/domestic investment and stabilisation. Mr. Rietveld stressed that the Norwegian model cannot be applied in its exact format in Africa due to differences in the economic set up and the urgent need for infrastructure development.

viii. With regards to the timing, Mr. Rietveld underscored the fact that setting up and equipping a SWF is a small part of the larger picture. It is part of the rule-based framework. The real and most important consideration is the creation of sustainable fiscal policies.

ix. Despite the importance of pressing urgent need for domestic investments, the earning power of capital – oil to equities – cannot be overemphasized.

3.1.9 DISCUSSIONS

Mr. Patrick Mutimba, Director Financial Sector Management Programme

Mr. Mutimba sought additional clarification on the rule-based framework particularly on how soon countries could start, and if the presenter could recommend a rule of thumb. He also cited an article written by Dr. Fundanga in the MEFMI Forum Issue 17, in which he raises the case for African countries to re-examine the sources of funds to invest in infrastructure.

He highlighted the fact that African countries have foreign exchange reserves, which they currently invest in safe and liquid markets at low rates, for example, the six (6) months LIBOR at 0.46%, yet a country like Ivory Coast issued a Eurobond at 6.5%. He underscored this as an example where African SWF could benefit from a yield pickup without compromising their objectives of maintaining a foreign currency hedge in liquid and safe markets.

Dr. Louis Kasekende, Deputy Governor, Bank of Uganda

Dr. Louis Kasekende, Deputy Governor, Bank of Uganda, reminded the delegates that the focus should be on economic transformation and diversification of African economies with or without oil (resource) revenue. His argument was that from the presentation, the case put forward was on accumulating savings to assist with the stabilisation of volatile resource earnings. He went further to add that economic transformation is possible where there are savings applied in any given proportion of about 30% to 40%. However, he argued that having accumulated savings was not an end in itself but should be seen as an avenue towards economic transformation.

Dr. Kasekende further emphasised that economic transformation is a more complicated issue, where a country spends money to build a stadium or to construct a road, the investment choices and the use of fiscal rules to make these choices as brought out in the presentation are different from the fiscal rules that are present in African countries. The fiscal rules mentioned in the presentation are necessary for avoiding the boom-busts in commodity prices manifested in the boom-busts in fiscal revenue.

He went on to state that leveraging revenue to finance economic transformation and reducing dependence is the most complicated question faced by many countries in Africa. He highlighted the need for economic and institutional capacity that will help transform government expenditure into government projects that will lead to economic transformation; that is, allow for transformation of savings into assets above the ground which would lead to economic transformation. Dr. Kasekende noted that the key factors in that transformation are the political economy and the capacity of government to make appropriate choices.

Dr. Denny Kalyalya, Governor, Bank of Zambia

Dr. Denny Kalyalya, Governor, Bank of Zambia, pointed out that the presentation brought to the fore issues which African countries are grappling with. He further stated that the presentation provided clearly the way forward for countries once they are in the SWFs arena.

However, he noted that the tug of war for some of the countries which are resource rich is on the one hand poverty which is bearing hard on a country, while on the other hand there is talk about diversification as one way to leverage the resources and build the capacity to achieve the objectives laid out. He underscored that the question was how a country can position itself as a policy maker and which components should be addressed first in the decision making process.

Governor Kalyalya further highlighted the case of Norway, noting that the model used is simple but with its own shortcomings - that of using the same commodity to build the revenue – which may not allow a country to diversify its revenue base. In that context, he sought clarification if there existed a threshold of revenue that can be expected and/or stipulated, whereby if revenue fall before that revenue level is achieved, a country can activate certain actions.

On diversification, Dr. Kalyalya further raised the issue of the dominant political economy and linked it to investments and sought to know how a country decides which way to go based on the model presented.

Dr. Kalyalya also pointed out that the presentation had not been specific on the infrastructure that a country should focus on, given the numerous interpretations of infrastructure.

Dr. Abdul-Nashiru Issahaku, Second Deputy Governor, Bank of Ghana

Dr. Issahaku highlighted the need to decouple SWF from government spending in investment and sought Investec's position on the sufficiency of Ghana's decoupling from government spending.

In the Ghana model, revenue is directly allocated to the budget (annual budget funding amount) and anything in excess of the stabilisation fund is put into financing the budget.

Mr. Majozi Sithole, Governor, Central Bank of Swaziland

Mr. Sithole pointed out that the presentation tackled fiscal policy, something that is not necessarily under the control of Central Bank governors, but noted that this was important because whatever a country is saving, will ultimately be spent. In this regard, he pointed out that there must be clarity on spending for economic transformation – not unnecessary spending which will not help in growing and transforming the economy.

He also stated that when seeking to establish a SWF, there would be numerous questions on choosing to save money in the face of poverty. However, he pointed out that the approach was not the best way to address the issues of poverty as fiscal policy rules were important, when considered with sustainable means to address the challenge of mixed needs now and in the future.

He sought clarification on the right time and the best approach to use to convince government to establish a SWF. He pointed out that countries are naturally faced with numerous challenges, but when they come about a windfall from natural resources, when is the best time to discuss the formation of a SWF? The counter-argument expected is the many challenges which require to be addressed, however if the windfall is not harnessed the poverty cycle would never end.

Mr. Ernesto Gouveia Gove, Governor, Bank of Mozambique

Governor Gove argued that economic transformation is all encompassing but the emphasis on industrialisation is missing. Furthermore, he argued that extracting natural resources and saving does not transform an economy. Therefore his concerns were how to transform economies from exporting raw materials through domestic industrialisation.

He cited the case for Mozambique where industrial development strategy includes processing and adding value domestically. In addition, not undertaking investments in portfolios which have low return and which may also involve losing money given the low interest rates in the international financial markets.

Governor Gove further argued that with the existing huge infrastructure gap in the region, domestic industrialisation and infrastructure are critical.

Dr. Lesedi Senatla - Deputy Director, Monetary and Financial Stability Department, Bank of Botswana

Dr. Senatla expressed support for the idea of having a strategy and rules in making savings. He also argued that it is important to have savings from natural resources. He said this comes with a moral hazard since as a country accumulates assets, it becomes more credit worthy which attracts lenders wishing to do business. If this is not carefully assessed, a country may be tempted to over borrow which may lead to running down reserves to repay which depletes the savings.

Furthermore, Dr. Senatla argued that savings need to be invested and the choice of investment instruments is very important. This is a complicated process as it involves many choices, such as the appropriate currencies whose exchange rates may work against a country. He stressed that capital preservation must always be ensured.

Dr. Caleb M. Fundanga, MEFMI Executive Director

Dr. Fundanga stated that, he led a delegation of senior government officials from Zimbabwe to Norway in 2014 to learn about the Norwegian experience and noted that the team witnessed the impact of huge wealth accumulation on monetary policy.

Dr. Fundanga pointed out that countries have a choice to keep natural resources underground or extract and transform them into financial wealth for investment, which is what Norway did. Similarly, he said another way of looking at it is to leave the resources underground until the returns are favourable.

The key question is when and how to know about the sustainability of a boom and a bust and fixed rules become more appropriate for cyclical policies. He pointed out that the African Development Bank has initiatives to develop regional bonds which make the case for diversification of African bonds.

He further stated that some countries can take a speculative stance and decide to hold onto their natural resources un-extracted until the right time when the prices are favourable. Thus the way forward is the extraction of the natural resources and the investment of the resource revenue in assets yielding good returns.

He underscored the need for application of rules-based frameworks as in the case of Norway where they do not allow investment in the domestic economy.
Dr. Fundanga pointed out that the greatest take home from the tour was that the Norwegian SWF could invest in an African company based in, for example, Zambia and by extension, if African countries were to start building their SWFs, it is

possible for such rules-based practices to become a common feature - investing in different economies on the continent.

He stated that there is a strong case against investing in the domestic economy because of political interference. However, if investments are rule-based and investments are in other economies, political interference is not as strong.

He also cited the case of Botswana as a good success story and underscored the need to closely study the case which has a stable policy environment and one of longest running SWFs.

Mr. Otieno, Director Debt Management Programme, MEFMI

Mr. Raphael Otieno, Director Debt Management Programme MEFMI, appreciated the model put forward by Investec. He pointed out that the impression received is that the model allows for a smooth expenditure pattern throughout, but it does not seem to allow for the flexibility to sometimes increase expenditure depending on the different business cycles. He further pointed out that the importance of increasing expenditure when there is a slump in the economy to stimulate it and vice versa when the economy is doing well and when resources from other sectors are coming through in larger quantities from the stabilisation fund. Mr. Otieno sought clarifications on how a country can address that, and whether the model provides for that.

Ms. Katherine Tweedie, Executive Director, Investec Investment Institute

Ms. Katherine Tweedie, Executive Director of Investec Investment Institute commented on some of the questions raised, particularly, on the tension between putting funds aside to generate long-term savings and political pressure to provide jobs, put up critical infrastructure and tackle poverty. She explained that in the case study of Saudi Arabia, it was a major topic of discussion and Dr. Khalid spent considerable time addressing two components on the structure of various funds whereby it was proposed to have:

i. A stabilisation fund or a long-term endowment savings fund; and

ii. Earmark capital specifically for local development/investment.

She pointed out that this was to be closely aligned with industrial policies looking at the right investment in the region for diversification. In addition, Ms. Tweedie pointed out that on working with SWFs, Investec has been doing some innovative work on economic diversity with Professor Haussmann particularly on how a government can make smart choices and stimulate certain key industries that make sense for the particular region.

She noted that Africa is sitting on significant natural resources wealth, however, the skills set and the support required to go into mining and production of sustainable assets is significant and it is necessary to look at smart industrial policies which make the right step and right investment to catalyse jobs and economic diversity.

Responses by Mr. Malan Rietveld

Mr. Rietveld pointed out that once a country starts to receive resource revenue, for political and practical reasons, it is difficult to take away from those institutions and structures which have been receiving and benefiting from the revenue. He argued that it was easier to establish the rules, ensure they are understood by all and are applicable from the time when resource revenue is first received. Further, he argued that it was not only reforms on use of resource revenue that were difficult; there is also the cost of delayed set-up and implementation of the SWF - the cost of depleting reserves rather than building on those which are present.

In addition, he argued that as reserves are depleted, there was loss of earning power which would have been generated. He noted that the fall in oil prices before production which has started in many African countries, provides an opportunity for scenario analysis and stress testing before the revenue arrive.

On the issue of savings and stabilisation policies, given the massive spending and investment needs in the domestic economies, Mr. Rietveld concurred with the points raised that there is no telling if a country was to apply a rules-based framework on what income from the SWF would be spent on.

He noted that in the case for Ghana, the budget spending is crowded out by two major items: public sector wages and debt servicing which have crowded out public investment.

He noted that a country can establish a mechanism through which the investment income from the SWF is earmarked for infrastructure development, however, there are few countries which have successfully done that.

Mr. Rietveld urged delegates to borrow from some American States which have endowment funds based on oil and gas revenue, with examples such as hospital fund, public education fund, and highways fund. They specifically use the income from a stabilised structure to create a sustainable predictable flow of income which the resource will not be able to provide because it is so volatile and unpredictable. It is then specifically earmarked in the budget to those particular and priority items.

Mr. Rietveld noted that this would depend on the political process and national legislation. Nonetheless, he argued that it would be a useful model to consider in the African context where there has been talk on infrastructure but there are massive other spending needs such as housing and urban infrastructure to cope with urbanisation - where money needs to be allocated.

He also underscored the need to create public and political buy-in towards these funds. With such stakeholders the message conveyed is that through this combination of policies a country can ensure or at least promote the generation of a stable, predictable and sustainable flow of income.

He cited the case of Ghana, where the policy is a 25% savings rate, which allows for a 75% spending/consumption rate of oil revenue and a massive increase in spending that provides a more predictable rise in spending. He noted that savings policies in the region of 25% for African countries with the institutional capacity to spend on the right projects are entirely appropriate. Mr. Rietveld stated that he would not call for a saving rate of 70% or more of resource income in African countries.

Mr. Rietveld further informed delegates that most countries with established SWFs have been born out of the recognition of very painful lessons about what happens when spending and investing resource income in its original state. He cited the cases of the start-stop policies witnessed in the Middle East and Norway which went through a painful process of trying to spend resource income without policies that stabilise and transform the resource revenue base.

He argued that Africa should build the needed SWF infrastructure rather than enabling a situation where commodity price declines cause projects to stop mid-stream. In this regard, having a structure on savings, spending and stabilisation means a country will be able to sustain the required infrastructure spending.

Mr. Rietveld stressed the distinction between savings, spending and stabilisation. He underscored the fact that if it is difficult to make a case for savings, countries should at least make a case for a stabilisation fund. He noted that there is little debate that a stabilisation fund is desirable and there is a clear case for it. The challenge with the stabilisation fund is how to operationalise it, and get politicians to stick to it when the going gets tough. He pointed out that the savings fund can be debated further and advised that savings of approximately 15% to 20% of generated revenue are adequate for an African country in general.

Further, with regard to Ghana's rules, Mr. Rietveld explained that from what is understood, the rules are good and the legislation is well specified. He pointed out that SWFs help on the asset side, while on the side of government spending there is usually massive borrowing with the resultant challenge of debt servicing.

In this case, a SWF or a fiscal framework around a SWF is not a solution. He argued that where possible, a country should extend the fiscal rule to cover both the asset and liability side of government. He noted that there are few countries that have been able to establish a rule that has kept borrowing and debt financing at a manageable level. Ghana has a structure of approximately 30% savings, and a stabilisation fund to cope with the volatility and Mr. Rietveld stated he had no qualms with Ghana legislation.

Mr. Rietveld noted that Norway is in the fortunate position of being a large oil producer generating significant oil revenue. However, the oil revenue only accounts for a fifth of public revenue. He argued that this was very different from a country which has 85% to 90% dependence on oil (resource) revenue. Thus for a country highly dependent on oil (resource) revenue, having fiscal rules that are based on the non-resource deficit would be impossible, as is the case in Nigeria. This is because the whole budget is based on resource revenue.

Mr. Rietveld detailed what the Norwegians did by taking approximately 20% of oil revenue and transforming it into the Norwegian Sovereign Wealth Fund. He noted that the investment income from the Norwegian SWF of 4% is now approaching 20% of annual revenue. They have thus almost fully achieved the transformation of oil assets to financial assets. However, this is problematic and difficult to achieve for countries which are fully dependent on oil (resource) revenue.

In addressing the question of adjusting spending policies dynamically to make them more actively counter-cyclical, he stated that it pointed to an analogy of rules versus discretionary monetary policy. He argued that Central Banks are well aware of the case for rules and the case for discretion and it is possible. He further noted that such a model is a variation of what numerous endowed institutions do, for example, American universities adjust withdrawals from a fund: in a year when they are receiving low student fees or sponsorship income, they tap the fund more aggressively. Furthermore, it is also possible that they have had no withdrawals from the fund in a particular year.

He cautioned, however, that due consideration must be taken because such a model has the potential to open the door for discretion which raises governance questions as to when to decide to adjust certain policies. He argued that with resources, there exists a knowledge/information gap/problem on what countries know about the current commodity slump and how long it will last. In case of a boom, the question is how long it will last; if it is a permanent or transitory shock; even with fixed parameters, there is a good degree of counter-cyclicality and stability. However, he underscored that given an appropriate governance structure; a country can look at more active counter-cyclical policies rather than just purely stabilising or fixed increases.

On investing in regional markets in Africa, Mr. Rietveld highlighted the work done and initiatives undertaken by the African Development Bank (AfDB) to support regional bond indices. He expressed confidence that once the appropriate structures are in place to ensure capturing and saving a portion of resource revenue, the next step will be establishing institutions that can support the stated initiatives. In addition, he noted that a case could be made under the banner of diversification, that by investing in the African bond markets, sovereign investors will support the development of local industries and deepening of capital markets.

Mr. Rietveld added that a stream of income from resource revenue can be used to support a particular budget item and that the same stream of income can also be used to create a stable and sustainable source of funding to a sovereign development fund.

He cited that there are several African countries, for example, Ghana and Nigeria which have established a savings fund, stabilisation fund and a domestic sovereign infrastructure development fund. He pointed out that one of the issues around the fund component is how to create a stable and predictable source of funding under the sovereign development institution that has a component and can match its incoming assets with investments that it must make, thereby linking the stabilisation and savings fund to the funding of the sovereign development fund.

Furthermore he noted that of importance are the governance issues around the sovereign development fund, including how projects are selected. He noted that Nigeria is very explicit in stating that they are comfortable with accepting a lower rate of financial return on domestic investments from the Nigerian domestic fund given the anticipated economic and social benefits associated with those investments. In this regard, the best thing about that legislation is that they have been explicit about it and have even put a number in terms of the mark-down on returns they are prepared to tolerate in support of domestic investment.

With regard to making the micro investment policy decisions of the type of infrastructure, Mr. Rietveld pointed out that trying to scale up investments in line with the actual resource windfall would be challenging bearing in mind the ability of a country to pick the right project and identify incrementally the right infrastructure. He noted that with a more flattened and graduated increase in spending; there are better chances of doing the right infrastructure investments, and ensuring that the Dutch disease bottlenecks are not encountered. He cited the case of Nigeria in the 1970s and early 1980s after the oil boom which tried to undertake a massive amount of active diversification in infrastructure investment. The result of inadequate capacity was the queued up ships outside the ports of

Nigeria for about 6 months trying to get in because the docking spots were not enough.

Mr. Rietveld noted that there are numerous bottlenecks involved with infrastructure development but the rationale which can be made in terms of the political economy is to be clear that having a SWF programme does not mean that there will be no infrastructure development. If anything, he argued that it was a way to ensure that it will be done in a sustainable and incremental manner.

Mr. Rietveld concluded with a discussion on an extension of the work done by Investec which looked at an economy's productive structure and analysed what a country is good at producing, looking at the quickest wins most associated and proximate industries which are ripe for diversification as a useful application for the potential for the work in terms of structural transformation and industrial policy diversification.

3.2 SESSION 2: ROLE OF CENTRAL BANKS IN MANAGING A COUNTRY'S NATURAL RESOURCES REVENUE: INVESTMENT AND INSTITUTIONAL CONSIDERATIONS

This session was presented by Dr. Ekaterina Gratcheva[5], Lead Financial Officer, Reserves Advisory and Management Program at the World Bank Treasury. The session was moderated by Dr. Sehliselo Mpofu, Director, Macroeconomic Management Programme

In her opening statements, Dr. Gratcheva pointed out that the earlier presentation by Mr. Rietveld was very rich and focused on the macroeconomic and fiscal role of SWFs and the comments from Governors and Deputy Governors had been illuminating on the extent of the issues that are faced by the region, in determining the most optimal way to mobilise resources to achieve development objectives for Africa.

[5]Dr. Ekaterina (Katya) Gratcheva, is the Lead Financial Officer, in the Reserves Advisory and Management Program (RAMP) at the World Bank Treasury. Since joining the World Bank Treasury in 1998, Ekaterina has held various positions across Treasury. Prior to assuming client management responsibilities in 2008, Ekaterina's primary responsibility was the development of investment policy and strategic asset allocation for World Bank Group's own assets and for clients' public asset portfolios. Since then she has been leading client engagements with sovereign wealth funds, ministries of finance, central banks and other public financial and development institutions in numerous countries, including Azerbaijan, Egypt, Indonesia, Kazakhstan, Libya, Russia, South Africa, South Korea, Tanzania, Ukraine, among other countries. Ekaterina holds a Masters of Public Administration from Harvard Kennedy School, Doctor of Science from George Washington University and Master of Science from Moscow State University.

She stated that her presentation would focus on more practical aspects of SWFs management once countries have agreed on the various macroeconomic management and fiscal policies that were described in Mr. Rietveld's presentation. Once policies have been designed, the focus would be on the role that Central Banks can play in managing assets to achieve sustainable income that contribute to the wealth preservation and sustainable management of SWFs.

In this respect her presentation focused on the theoretical concepts of governance and best practices on management of SWFs, highlighting practical examples of work done in several countries at various stages of design and implementation.

Her presentation and the ensuing discussions sought to answer the following questions:

i. What is the role or multiple roles that Central Banks play in managing a country's SWF - both the policy and the institutional aspects;
ii. What are the key advantages of Central Banks in those particular role(s)?
iii. Are there any disadvantages or shortcomings for Central Banks and if so what are they?
iv. What are the practical lessons from each country?
v. What are the key takeaways?

The presentation focused on four key parts:

i. A background on the role of RAMP particularly with regards to SWFs;

ii. International best practice principles and the focus of the World Bank Treasury as a practitioner. RAMP does not just analyse how funds are designed through their public disclosure documents but actually works with countries, helping implement the design of the SWFs. In this regard, the lessons and the best practice principles were based on the long-term Treasury observation and the long-term engagement with the SWFs as well as 15 year history of engagement with Central Banks in capacity building programmes;

iii. Review of country examples on SWF design. The presenter noted that Norway has been a widely publicised example and she had consciously excluded it in the examples in her presentation; hence would be looking at other countries which she hoped would be as insightful as the Norway experience; and

iv. Conclusion with key takeaways.

3.2.1 RAMP MEMBERSHIP

Dr. Gratcheva pointed out that currently RAMP has 58 members including some of the countries represented in the Forum. She noted that African Central Banks are the largest constituency in RAMP.

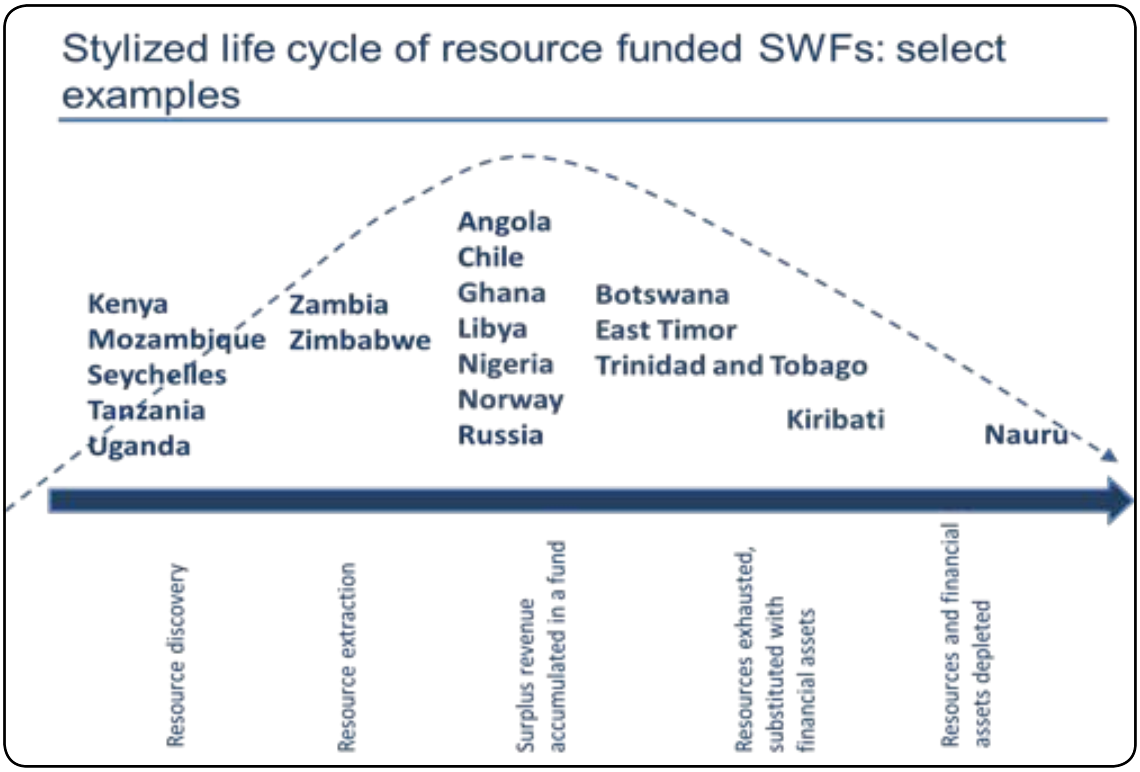
She pointed out that they have a variety of central banks in the Programme ranging from developing and least developed countries to upper-middle income countries with substantial levels of reserves of US$400 billion and more. This provides rich peer to peer learning as part of the RAMP programme through a variety of RAMP events such as training and seminars that are organised for members.

She indicated that RAMP has become more engaged with SWFs and although their number in the Programme is less than the Central Banks in overall terms, it is a growing constituency from all income types of countries. She further stated that the engagements range from the ones that have just been conceptualised where countries are considering appropriate macroeconomic and fiscal policies to those that legislations have already approved and the governance arrangements have been set up as shown in Chart 6 below. These latter categories are ready to build sustainable institutional arrangements through a central bank or an independent entity.

She pointed out that in some countries RAMP has been asked to review the existing arrangements, provide management appraisal and help enhance capacity and ability to increase return on their investment.

She noted that RAMP engagements are long-term in nature as they view institutional building, design and reform as a long-term process that can take many years. It is something that evolves in nature as global macroeconomics and financial markets change. In this regard, SWFs and the practice of best governance are on a continuous evolution to keep pace with changing conditions within the country, global financial markets and new sets of challenges that may come up.

Chart 6 – Life Cycle of Resource Funded SWFs



3.2.2 EVOLUTION OF SWFs

On evolution of SWFs, Dr. Gratcheva pointed out that SWFs date back to the 1950s and there are basically three (3) distinct phases in the SWF design. These are the pioneers, the classical design, and the New Phase.

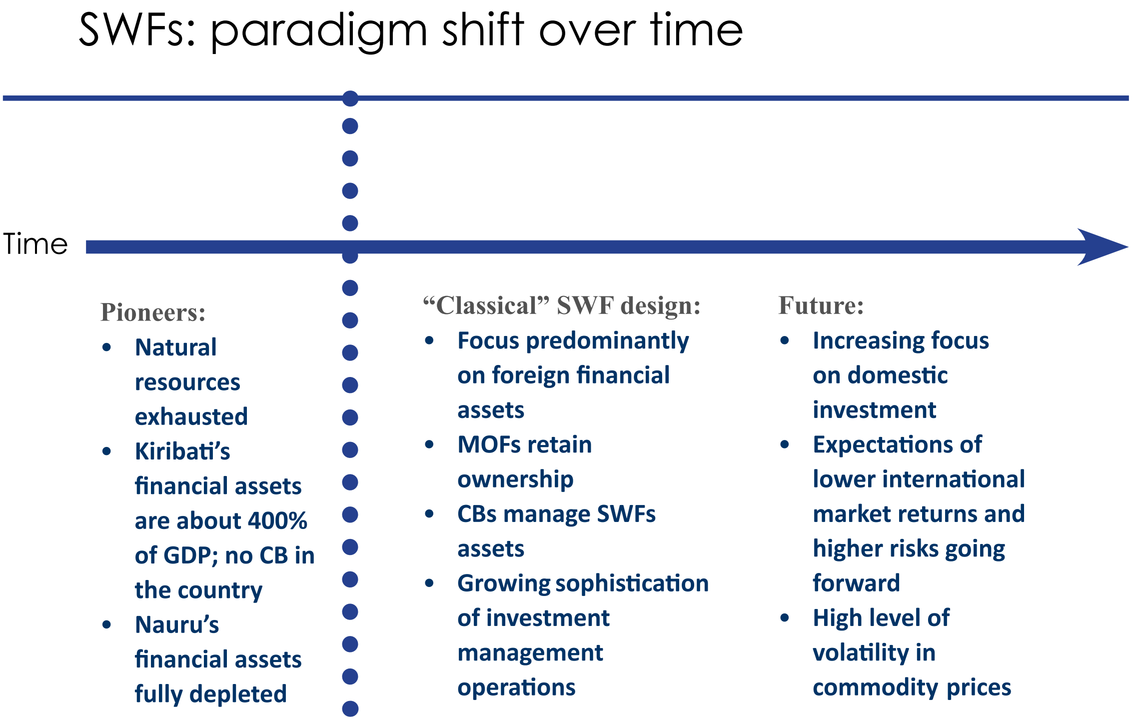
Similarly, on typology, she noted that there are two (2) specific classes of SWFs that were excluded in her presentation. These are the old oil funds such as Kuwait, Saudi Arabia and others which were set up in the early 1950s. She indicated that RAMP is not involved in Middle East SWFs.

Another set of SWFs that were explicitly excluded in the presentation are those that have been created from surplus foreign exchange revenue. In this category, are commodity related SWFs and non-commodity related SWFs. In non-commodity related SWFs, there are two sets of institutions; on one hand, there are those that have been created for countries with surpluses of foreign exchange reserves and they have been set aside and managed in separate institutions such as China Investment Corporation and Korea Investment Corporation. They are interesting in themselves but they have a different set of context which is relevant for a different type of discussion. The presentation included an example of a fund that is non-commodity related but stems from fiscal surpluses. This can be treated as a commodity-like SWF that has been created as a result of sustainable fiscal surpluses.

The Nauru and Kiribati Cases

The three distinct phases in the commodity-related or fiscal-surpluses related SWFs are the least known Kiribati and Nauru and they are quite interesting in themselves because, for example, the Kiribati SWFs was created in 1956, several years after Saudi Arabia's (1952).

Chart 7 – SWFs Paradigm Shift



Kiribati presents an interesting country case where the natural resources that were financing the fund have been exhausted and it has the largest SWF in relation to GDP, at nearly 400% at a time when there is no reliance on extractive industry, as the commodity was exhausted several years ago. The income from Kiribati represents, by far, one of the largest contributions to the country but has very limited development potential. Like Papua New Guinea and East Timor, Kiribati is a small island country isolated in the pacific, yet with a very interesting perspective of what happens in a country that had abundant natural resources, which have been exhausted but was in a position to set up funds to create financial assets to sustain it going forward.

She argued that Nauru is very similar to Kiribati in that its financial structure was modelled after Kiribati natural resources had been exhausted but unlike in Kiribati, the financial resources in Nauru have been exhausted due to mismanagement and corruption among others.

The two cases therefore present quite insightful lessons for the discussion especially given the test of time and how macroeconomic and fiscal situation and economic development evolves for different countries.

Classical SWFs Design Created between 1980s to Early 2000s

The presenter argued that Botswana, East Timor, Norway, and Trinidad and Tobago would fall under this category. The World Bank Treasury was involved in helping these countries set up these funds. The interesting lessons from these were that they are characterised by the very classic design, where the focus is on accumulation of foreign assets and pension funds and where all the development spending goes through the budget.

In these cases, the central banks are the agents to manage sovereign assets on behalf of the ministry of finance. The ministry of finance plays the role of the owner of the assets and has significant responsibility for how the fund should be managed and delegate specific instructions and investment mandates to the central bank.

At the same time, as markets are becoming more sophisticated, so are central banks and one could see a tendency with the central banks to continue to expand their capacity for investment management and move from pure liquidity management to a more asset management approach that also benefits the institutions that are involved in the management of sovereign assets.

New Phase

The completely new phase is categorised by two major characteristics as voiced in the previous presentation. These are: the increasing focus on domestic investment because the discussion is shifting from middle to high income countries to the countries with the most infrastructure needs and significant development challenges.

At the same time **expectations of financial returns and risks are skewed towards low expected returns, greater risks and greater uncertainty**. There are more evident trade-offs that have increased and are prominent in the current debate, which is the trade-off between accumulating foreign assets and investing in something that will not generate the kind of returns that others have been able to experience, and remain accountable to the domestic constituency with increased calls for improved investment in the domestic economy to create jobs.

The presenter concurred with earlier arguments by Mr. Rietveld that it is becoming clear that there is volatility and uncertainty in commodity prices. She noted that there are big cycles in the commodity prices but there are some voices that argue that may be this time it is different and perhaps there are substantive fundamental shifts in how the resource is consumed and extracted as that would put more downward pressure on commodity prices that may raise questions on some of the fundamentals on how SWFs are created now vis-a-vis in the more classical phase.

3.2.3 GOVERNANCE OF SWFs

Dr. Gratcheva emphasised the underlying nature of SWFs, which are different from the foreign exchange reserves that are managed by the Central Bank. In this regard, she argued that foreign exchange reserves are owned by Central Banks, which tend to be independent and are the principals of foreign exchange reserves management. This gives them the authority to make decisions on how those funds are invested in order to achieve institutional objectives for the Central Bank according to the underlying monetary policy objectives.

On the other hand, SWF assets or revenue coming from natural resources are different in the sense that they come from underground, within the country's landmass and essentially do not belong to any institution. They belong to the country itself comprising of current and future generations. As such, representation of these assets does not reside in one institution but in many institutions and owned by a collective population, a constituency and as such, they have to be represented and managed accordingly.

Dr. Gratcheva argued that this is the key reason why when talking about SWFs, it involves three constituencies: Parliament, Ministry of Finance and the Central Bank. This is as a result of the fundamental nature of the revenue from the SWFs.

However, the resulting challenge from this underlying arrangement comes from balancing two key objectives. Firstly, how to have an informed policy making and representative ownership of the asset which clearly resides in a representational part of the country, such as Parliament and secondly, the explicit delegation of authority of accountability for implementation of the asset management position to a highly specialised entity.

She pointed out that, it was quite clear that parliament can express interest in the rights of being representative of the people, but it really is not in a position to make relevant decisions on how the funds should be invested and less so on implementing policy decisions.

She argued that it is these inherent tensions that the call for institutional arrangement for SWFs is trying to address. She further noted that those governance principles and institutional arrangements would be quite distinct if reference was on the management of foreign exchange reserves.

3.2.4 INSTITUTIONAL CHARACTERISTICS OF SOVERIGN FUNDS AND THE ROLE OF CENTRAL BANKS

Dr. Gratcheva noted that in order to see how funds should be managed and to bring out the role of central banks, there was need to separate the institutional characteristics of funds into three categories, namely stabilisation, endowment and domestic investment funds.

Stabilisation

These are much more aligned with foreign exchange reserves especially in countries where foreign exchange reserves are plentiful and where the management is not just focused on providing day to day liquidity management but also enhancing returns within some annual risk objectives. They usually have very similar investment objectives as non-negative return over a particular investment arising and in some countries they take it a little further because they think that the cycles in the commodity prices have a little longer half-life than say an annual accounting horizon hence they target longer time durations than the call of the foreign exchange reserves. Stabilisation funds are more short-term in nature and focus more on liquidity.

Endowment Fund

The endowment funds are no longer concerned with preservation of liquidity and generating returns. The focus is on the long-term sustainability and generating real returns rather than nominal returns. Hence, protecting the core principal and the purchasing capacity drives how one would manage and the relevant associated investment policies.

Domestic Investment Funds

With regard to this category, the central bank would play the least role because of their investment nature. This requires an institution that looks at investment opportunities at home and makes investment decisions which require skills and governance management which are different from those in deciding assets in international financial markets.

All these objectives are not hypothetical as they impact the generation of wealth for the country.

There are periods of significant drawdowns which overtime can become significantly higher. Diversifying to other assets smooths out volatility during market crises. The presenter noted that the governance and management of institutions should provide enough resilience to weather the storm in times of financial market distress.

She argued that the establishment of SWFs in the 1990s before the financial crisis of 2008 was easy because markets were more vibrant with bond yields on the decline and equity markets generating double digit returns. It was difficult to anticipate the types of financial crisis that would be coming. It was therefore smooth sailing for many SWFs in parliament. The challenge was how these institutions were able to withstand the times of market turbulence. The strongest governance structures were able to hold on to their investments and their investment strategy and mandate and came out stronger with greater wealth at the end of the period.

But there are a few examples of countries that were affected and have been questioned and as a result have been unable to get back to sustainable investment strategies and similar investment returns that they enjoyed previously.

She argued that some of the key questions for the governors and deputy governors include what it would be like to defend their particular fund, the way they are invested in front of the parliament and be able to account for increased wealth as well as some periods of negative returns. Furthermore, would they do anything different if they knew something that they are likely to face beyond the management of foreign exchange reserves? How would the approach to managing those particular assets adjust for the difficulties? These are things that cannot be taken literally when working with SWFs because every single one has a huge impact on the final product.

The presentation argued that there is need for clarity of the institutional objective, based on the following questions:

- Is it a short-term or a long-term fund?
- What is it going to be used for?
- What are the potential claims on this fund?
- If it is a stabilisation fund, what are the contingent liabilities on these funds?

Many countries are not only using the budget deficit as a particular trigger for the drawdown of the stabilisation fund, but that countries are including exogenous shocks, extreme weather events as triggers for drawdowns. Particular geographic regions have catastrophic weather events where SWFs are drawn down to provide the first line of defence for reconstruction.

The presenter argued that there were several ways as well as sources of SWFs, and these determine consideration on how they would be replenished, how the fund would be invested and their appropriate investment policies.

3.2.5 Key Considerations

i. Informed policy making and the ownership of the risk return is a challenge.
The trade-offs between domestic spending or investing in a particular asset class and decisions to go into equities knowing the probable risks of getting into negative returns is significant in the current market conditions. The question is how to make the most informed decisions using all the relevant and best information available; how to justify to the board; and how to own up to such decisions?

ii. Delegation of authority and accountability is critical
As indicated earlier, the citizens own the asset and delegate the management to a legislative body. What is the explicit mandate? What is the accountability principle? How is the institution that is the agent being held accountable? How is the institution measured, to determine if it is doing a good job or has failed to execute its responsibilities? How is the failure of execution of mandates addressed?

iii. Control and oversight roles are key
In situations with difficult investment discussions and challenges to governance within a country or within institutions, it will be very difficult to validate whether everything is done to exercise judicious implementation of oversight.

iv. Transparency and communication
This warrants a role of its own and it is not only to the periodic annual and investment reports that the institution has to provide to the public, this is viewed in a much broader sense. It is where all the different interested bodies and stakeholders buy into the country's concept of having a sovereign

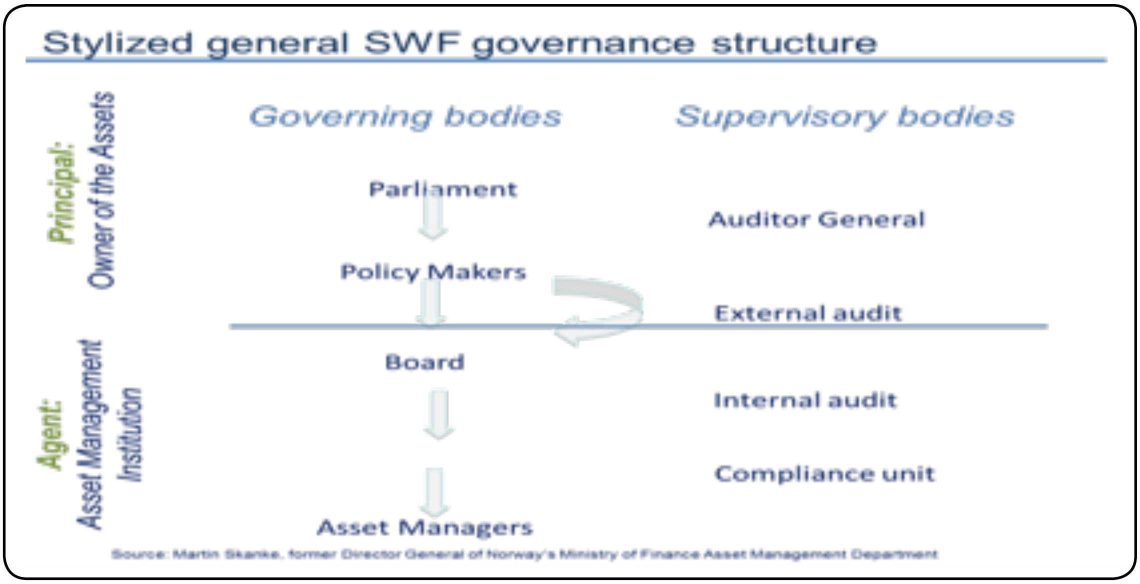
wealth fund. Long-term sustainability may sometimes be challenged if the civil service questions the validity of the design in the first place.

3.2.6 Governance Structure

To put the governance structure on more concrete terms, there are stylised minimum requirements for SWFs governance structures which provide an informed way to look at the roles of all parties in governance and supervisory roles.

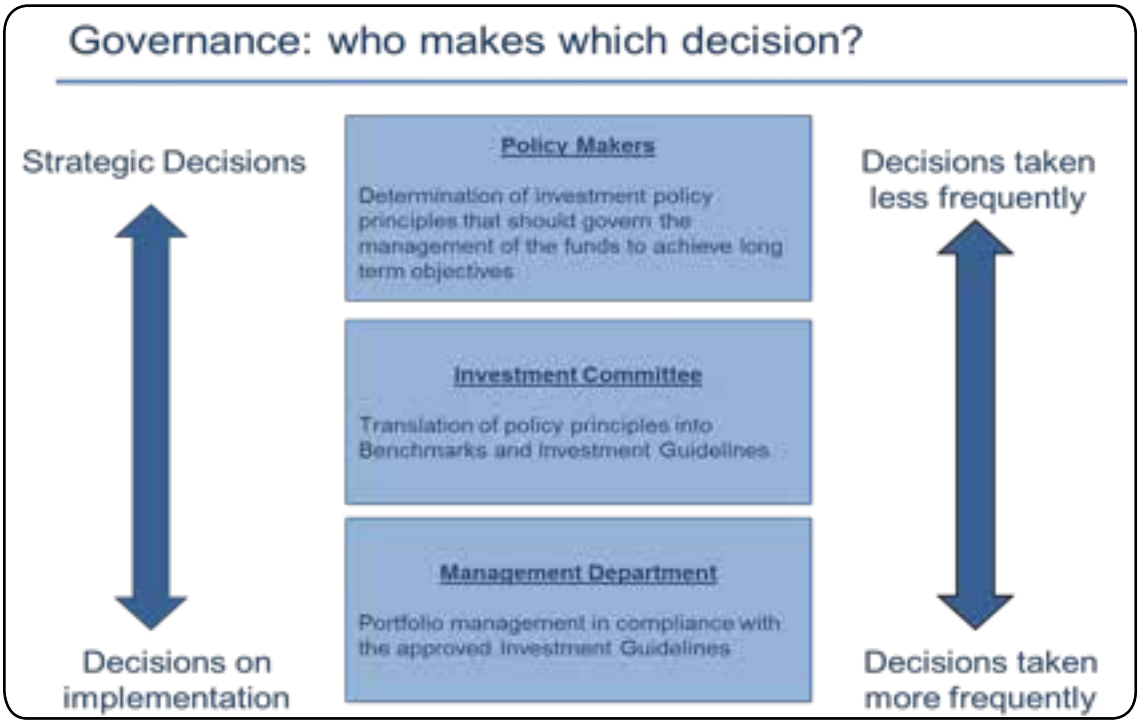
As indicated in Chart 8 below, generally, there are two sets of players in managing SWFs; the principal or owner of the asset and the agent or management company. Going down the value chain, from parliament to policy makers, there are two sets of managers; portfolio manager sitting within the central bank or external asset managers contracted to execute particular investment mandates.

Chart 8 – SWF Governance Structure (general)



As indicated in Chart 9 below, there is an increasing degree of delegation and specialisation in making the relevant decisions. Parliament for example would be responsible for deciding and approving whether it is a stabilisation fund but it would not be in a position to decide on what should be the risk tolerance on the investment horizon of each of the funds. They only set the overall objective for the type of the fund that they are comfortable with.

Chart 9 – Decision making



It is for the policy makers to make more granular decisions with regards to specifications of the fund. These specifications include the specific asset allocation portfolio and the investment horizon. The main questions to consider here include:

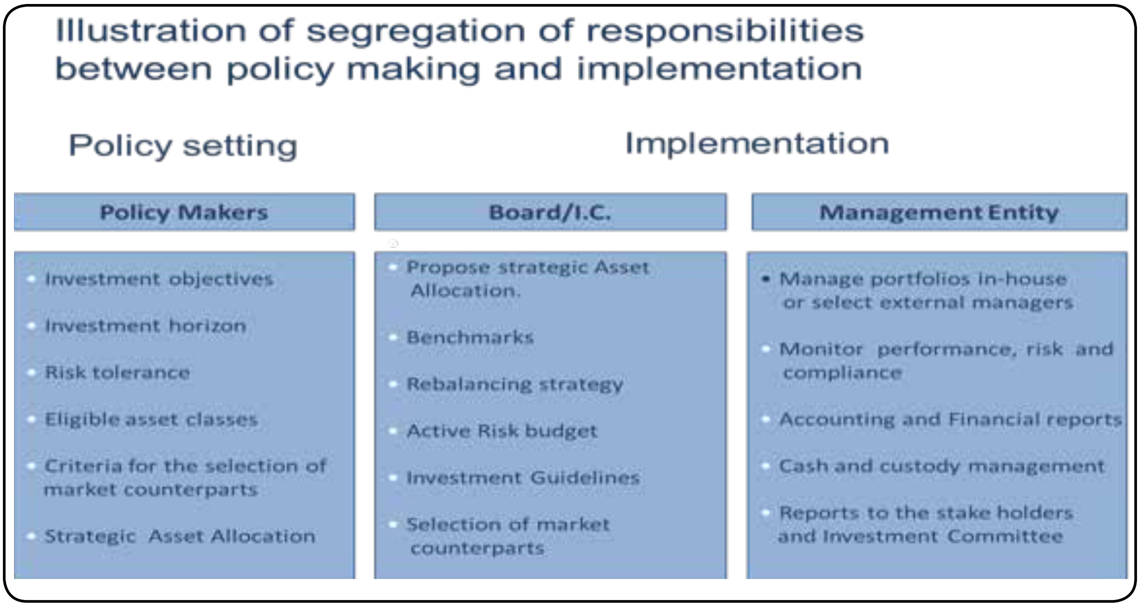
- What is the strategic objective?
- Is there a return target?
- Is it a nominal return target or a real return target?
- What probability of the drawdown is the policy maker willing to tolerate?

Once all these decisions have been made further delegation into more specialisation areas involves going to an asset management company and into implementation of all these decisions. The authority to execute the policy resides in the board of the asset management institution.

The Chief Executive Officer (CEO) specifically executes it in financial markets across different sectors through a combination of internal verses external asset management. Granular delegation with increasing specialisation on the different specific objectives at the bottom is done through specific asset managers.

Parliament would not necessarily understand what fund managers are doing but they have to be able to understand that the policies they are making have been implemented and that it is the responsibilities of the chain of command packaged in accountability from the bottom up as shown in Chart 10 below, to ensure consistency with the overall policy design.

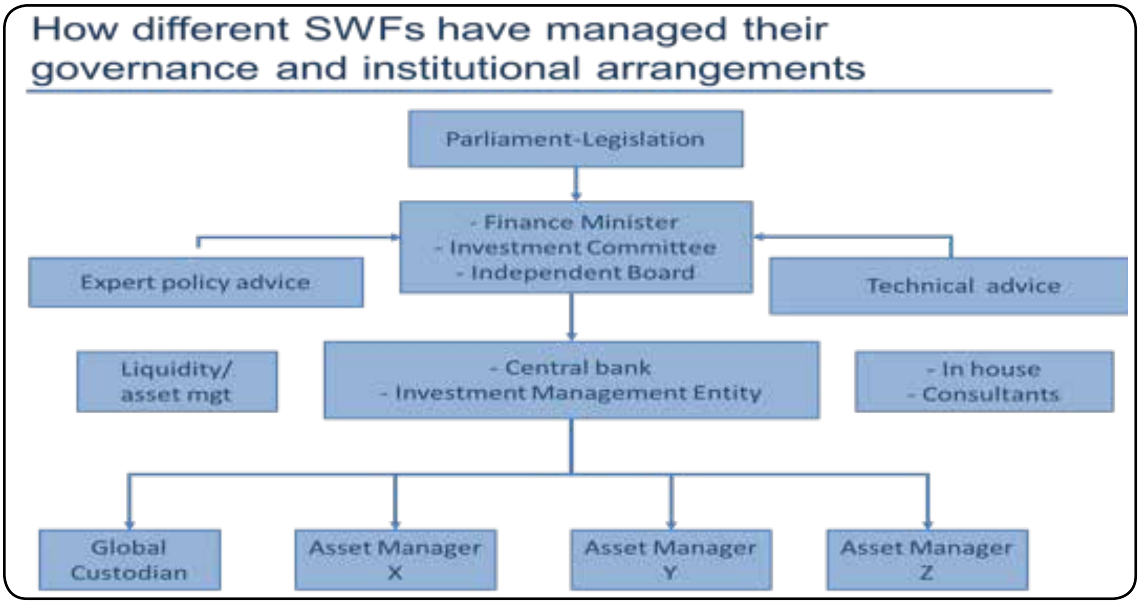
Chart 10 – Segregation of roles



The supervisory bodies would be a combination of internal and external audit bodies responsible for specific decisions. The auditor general office has a key role to play but if it is not highly specialised, it would be advisable to seek the services of private sector auditors.

In a more classical design of SWFs, the ministry of finance, through various investment committees and independent boards, functions as the policy setting body for SWFs as shown in Chart 11 below.

Chart 11 – Governance structure



Central banks have predominantly been the investment management companies but in some cases independent companies perform this function. Investment management entities, separate from the central bank are more typical from the countries that have foreign exchange surpluses such the China Investment Companies and Korea Investment. Countries with commodity SWFs have fewer examples of separate independent investment companies.

Unfortunately, there is a case of institutional failure in one country in Africa, Libya, where two entities have been involved in managing the SWFs: the central bank which managed the stabilisation fund and the Libya Investment Authority which managed the long-term endowment fund. They experienced mismanagement and other serious issues that have led to significant loss of funds.

In summary, the issue of the slightly different perspectives of how to separate policy making from implementation is to think of the frequency with which certain decisions have to be made. For example, portfolio investment managers within Central banks and investment authorities need to make decisions on a daily basis. This indicates that those decisions have to reside at the very bottom of the implementation pyramid with highly technical skills.

Similarly, one would not expect the investment committees; the board or top policy makers to be involved in financial markets on a daily basis in order to be tuned in on what is going on in the market to make relevant decisions. The policy makers are more concerned with the long-term nature of the results generated by different institutions. These activities don't require them to have more frequent meetings, but rather quarterly or sometimes annually.

3.2.7 DECISIONS ON APPROPRIATE INSTITUTIONS TO MANAGE SOVEREIGN WEALTH FUNDS

The presenter pointed out that the million dollar question is whether there is a fundamental belief in a country that one institution can achieve multiple objectives or one institution should run only one mandate. In principle, she underscored the view of the World Bank which advocates for segregation of different objectives in different institutions. In this regard, the World Bank tends to recommend the implementation of one objective, one instrument. However, she noted that some countries at the moment are thinking of an institution with multiple objectives such as the objectives of domestic investment and managing an endowment of an asset as is the case in Angola.

Institutional Autonomy

The cardinal principle which is required is institutional autonomy. It is critical to have political independence and be shielded from any form of political interference. Many institutional failures have occurred exactly because of the political interference. There is a direct relationship between the independence of an institution, the independence of the board and realised returns.

The derivate of these is the budgetary arrangements and procurement procedures which enable these institutions to maintain that independence going forward. It is difficult to argue that an institution is independent if it has to go to parliament to ask for budget allocations on a regular basis or to be recapitalised. Thus, to have an independent budget is one of the indications of potential insulation from political interference.

Legitimacy

As the funds have to be engaged in international financial markets with many international players, legitimacy of institutions is critical especially currently with greater regulation and know your client policies. There will be scrutiny and due diligence on the institution before any investment partner signs any legal agreement or contract with the particular entity.

Operational capacity

The question here is whether the institutions have the various preconditions in order to develop capacity and investment infrastructure to implement best asset management processes. The human resource aspects of investment management are critical because investment management is highly skill intensive and more sophisticated portfolios require even greater emphasis on skilled personnel. To be able to attract and retain qualified staff, it is necessary to develop the capacity for more sophisticated investment management.

Legal Issues

The legal issues regarding asset management are particularly important for developing countries especially because of the issues of sovereign immunity and the risk of attachment. Some countries like Norway have not had to defend themselves in court against particular litigations on the country's sovereign assets; however these are more common for developing countries. These issues thus become an overriding principle on the decision of who should be the asset manager. There are also issues of taxation as well as enforceability of legal contracts of the partners.

The Case for the Central Bank

With these key considerations for design of the asset management company, one can look at whether Central Banks are appropriate for managing SWFs.

Within most countries, Central Banks tend to be independent institutions from government and also with technical capacity. In countries with less developed financial markets, the Central Banks are the centres of excellence where the most qualified students and skilled professionals get the privilege to work.

However, as they continue to grow in expertise and skill, they become an attractive target by a developing private sector financial industry or even global financial industry. These are the pros and cons for the Central Bank. It can attract skilled personnel, but the human resource policies tend to limit public sector compensation and do not allow it to compete with private sector salaries, thus they are not able to retain the established skills.

In terms of legal issues, Central Banks are by far the strongest immunity for assets. In this regard, it is clear that if funds are managed by Central Banks, they get the same protection under certain conditions as the country's foreign exchange reserves as was the case in Russia when it had litigation. There are other additional criteria that also have to be satisfied. This is why Russia chose the Central Bank as the asset manager even though there existed legislation to create an independent entity to manage assets with a greater focus on long-term investment returns.

Furthermore, given that the Central Banks are long-term players in financial markets, they have existing relationships with the global financial markets. They already have legal documentation with the partners and this becomes a lot easier for them to extend the same type of contract to manage the assets on behalf of the SWFs.

An important aspect for the Central Bank is the corporate culture. The historical focus on liquidity management by Central Banks has instilled a predominant culture of capital preservation. This corporate culture plays quite a significant role on how assets are managed by the Central Bank. Central Banks are therefore much more conservative than other entities even when allowed more leeway and given the investment mandate to generate long-term returns.
The case for an Independent Entity

For independent entities, especially if they have to be established from the scratch, history shows that it is quite a challenge especially in developing countries with different governance challenges to ensure that there is independence.

In some countries the independence exists on paper but it is not practised. It is possible to have a board that is independently selected and has all the qualifications which are required for selection and appointment of an independent board but a call from a president would override all the decision making of that body.

The de-facto independence or lack of independence will inevitably compromise the quality of decision making. That aspect is quite challenging and in practice the most successful independent entities are in highly developed countries with more established governance practices which can defend their independence from political bodies.

Legitimacy also needs to be established. Knowing your client and customer becomes a high order.

However, on the operational capacity, because there are no legacy relationships and infrastructure, one could argue that being new provides a clean slate to implement the best and most contemporary best practices.

Furthermore, since an independent entity is not subject to public sector regulation, the human resources policies would not be constrained and would be able to offer competitive compensation packages such as bonuses and return-based incentives for personnel to implement sophisticated asset management operations.

Legal issues are also quite challenging particularly with regard to immunity and succession. A lot of things would depend on domestic and international regulations. It certainly would not be treated with the same immunities applied to the Central Bank.

In summary, Dr. Gratcheva argued that the pros and cons between the Central Bank and independent asset management institutions is that there are no clear answers. There are benefits and shortcomings in each category.

3.2.8 COUNTRY EXAMPLES

In countries with commodity and fiscal surpluses, the Central Bank is the most predominant model. These include Chile, Ghana, Kazakhstan, Norway, Russia, and many others.

In some of these countries, they have started introducing legislation and implementing an additional entity that focuses more on long-term endowment funds where Central Banks still play a role in their management.

Within Central Banks, different treatment exists for each of these models. In some, such as Botswana and Russia and more recently Romania, these countries physically co-mingle foreign exchange reserves with the sovereign assets. This is basically for a variety of reasons that provide the strongest immunity and to have economies of scales in terms of investment infrastructure and staff operations in managing one co-mingled portfolio.

In other countries, there are just segregated accounts within the Central Banks. It could be in a national currency and in others there is a different dedicated department that is almost an independent entity within the Central Bank managing assets as in Trinidad and Tobago.

3.2.9 DISCUSSIONS

Dr. Louis Kasekende, Deputy Governor, Bank of Uganda

Dr. Kasekende argued that the issue of Central Banks' independence in the region has been tested over the last two years by some leaders who have terminated the terms of Governors before their end. He also noted that some Governors sometimes receive calls from state houses which are a pressure to Central Bank independence.

With regards to immunity, he sought to know if assets of SWFs managed by Central Banks would be protected from attachment. His argument was that if the funds are owned by the Central Bank, like foreign exchange reserves, then they would enjoy immunity. However, where the Central Bank has a delegated authority, separate from government, to manage sovereign assets, the assets would not enjoy immunity as was the case in Argentina which is different from the case of Russia cited earlier.

Dr. Kasekende also argued that the case for the independent asset manager set up within a country as indicated by the presenter may not be correctly reflected as this manager may be external such as Investec Asset Management, Goldman Sachs, or any other asset management firm.

Dr. Kasekende, further sought clarification on co-mingled SWF resources with reserves. His point was whether the Ministry of Finance decides the investment mandate unlike the case for foreign exchange reserves which are assigned to the Board of the Central Bank. He also stated that if SWFs are owned by the people, how could they also be owned by the Central Bank.

Dr. Lesedi Senatla - Deputy Director, Monetary and Financial Stability Department, Bank of Botswana

Dr. Senatla pointed out that under institutional governance; clarity is required between short-term and long-term objectives. He cited the case for the Bank of Botswana where there are two funds with two objectives of short-term liquidity portfolio management and long-term management, achieved simultaneously.

He also raised the dilemma of policy makers during exogenous events which could justify draw-downs by citizens but which might not be permitted at law and which could have an adverse effect on the government.

Dr. John Mangudya, Governor, Reserve Bank of Zimbabwe

Dr. Mangudya sought clarification on the optimal level of development for a country to develop a SWF.

Specifically on pre-conditional parameters, which countries have to meet.

Responses by Dr. Ekaterina Gratcheva

Dr. Gratcheva concurred with the points made by Dr. Kasekende on immunity and independent entities and clarified that if the Central Bank owns the assets, then they are immune. She cited the case for Botswana and Russia where the assets are physically co-mingled and the title transferred to the Central Bank. The sovereign wealth fund becomes a liability of the government.

She noted that this is different from having a separate dedicated department or a legal entity set up that can be interpreted by international law in London and New York as government assets for commercial purposes that can be attached on legal grounds.

In this regard, there are two conditions to consider: First, the owner of the asset which is the Central Bank verses the government; and secondly, the commercial nature. If assets are not owned by the Central Bank, but with delegated authority in segregated accounts, then it has to be proven in court that the assets are managed for commercial purposes or otherwise.

In the case of Russia, the title is transferred to the Central Bank and they have a more conservative investment policy in a similar way that foreign exchange reserves are managed. In this case, even if it is for future generations, the de-facto investment policy is limited to the hybrid fixed income portfolio like the foreign exchange reserves. This has shielded the assets and made them less vulnerable to international courts. Moving to private entities will upset this objective hence this is a tricky issue which has to be carefully considered and managed.

With regards to private asset managers, she argued that all of them are considered in a bottom-line where they are given an investment mandate to execute. But when talking about an agent on behalf of the Central Bank, it is still a decision making authority which has to be within the institutional design of a country's investment policy. This decision making will still have to reside within an entity within the country. If this has to be by-passed, then the implementation of the investment policy would have to move up one level in the finance ministry to directly contract a specialised asset manager to implement the mandate.

In some countries this design exists, where there is no Central Bank such as Kiribati and Panama. They do not have national currencies (with Kiribati using the Australian dollar and Panama using the US dollar). The governance structure moves decision making one level up. In Kiribati, parliament has more decision making roles including legislation and investment policy and contracts the private sector to implement mandates.

In Panama, there is a triangular relationship, to compensate for the lack of the Central Bank. They have an independent management entity on one side and a trusteeship with the largest state owned bank in the country. The ministry of finance sets the policy, determines the investment guidelines and implementation is with the investment entity that was newly created. There is trusteeship and very strong oversight function within the largest state owned bank. Other investment mandates are implemented through external managers.

In the case of co-mingling, Dr. Gratcheva pointed out that it should not be viewed to mean transferring decision making to the Central Bank. There is still clear segregation between policy making and operational aspects. Co-mingling in this particular example has to do with just operationalisation of the management of the reserves. The ministry of finance has an explicit role and stronger role in setting the policy of how these funds should be invested.

In the case of Russia, the ministry of finance is responsible for setting the investment policy and determining specific benchmarks that will guide the implementation of investment policy. The Central Bank has no discretion to deviate from the benchmark. In some other arrangements with risk budget characteristics, investment is the sole responsibility of the ministry of finance. From this perspective, the ownership function is separated from implementation and the implementation is the most appropriate given the immunity issue.

With regards to the case of Botswana, the presenter noted that there has not been an explicit objective separation in the stabilisation and savings funds and there is quite a degree of subjective discretion for the Central Bank to decide how funds are invested in the stabilisation or long-term fund. This has been cited as one of the potential weaknesses of the design of the fund which is something that has to be strengthened. It is recommended that a more explicit mandate be determined to clarify the objectives.

From the World Bank experience in asset management and other Central Bank perspectives, it is critical to have the mandates separated. It can be implemented in a joint portfolio or co-mingling but there has to be very clear parameters as to what the objectives are between the liquidity components. This is because discretion and personal interpretation, particularly in liquidity management, results in sub-optimal outcomes.

It was noted that Botswana has generated great institutional legacy and great impact. A key takeaway lesson from the Botswana case, is the need to have more explicitly set-out objectives for the funds and less discretion in terms of withdrawal both from the fund and contribution to the fund. This has been achieved with a more rule-based approach based on explicitly designed policy sustained over time.

Regarding justification to the population on the need to protect some of the funds for future generations, this scenario was referred to as politically motivated decision making. It was argued that in SWFs where politicians access assets, even with good intentions, quite often the funds get used for various unplanned purposes. However, if there is a particular contingency and there is no other alternative except to use these assets, there would be no complaints. Unfortunately, this provides a slippery slope for all politicians to find all the good reasons to spend on inappropriate causes, and regrettably in many countries this leads to a quick erosion of the capital base.

Therefore, in order for protection from these kinds of scenarios, it is important to build consensus domestically as to how the funds should be used. There should be a clear approach on contingency and conditions for draw-downs. Similarly, to protect a wealth fund for future generations from finite natural resources, the resources should be invested with a long-term objective.

With regards to the comment on preconditions as alluded to by Dr. Mangudya, the presenter argued that SWFs exist across the full spectrum of economic development and they have achieved significant results. In the case of Kiribati which is fourth from the bottom in terms of development ability, without SWFs, they would not have been financially sustainable. This reinforces the message of prudence and foresight, which has put them in a much better position in spite of their developmental challenges. They benefited from the great run in financial markets prior to the global financial crisis.

SWFs are even more appropriate for countries with low levels of governance in view of the fact that on average, SWFs are better governed than countries overall. This is another argument to say that governance issues and perverse incentives are difficult to eradicate overnight. In fact, starting with well governed SWFs, gives the opportunity to build a centre of excellence which can become the centre in which good corporate governance practice can influence other institutions in the country.

4 VIDEO INTERVIEWS

Dr. Caleb M. Fundanga, MEFMI Executive Director

Dr. Fundanga underscored the fact that the Forum is for Governors of Central Banks in the MEFMI Region. He stated that the Forum was being restarted with Investec Asset Management as the financial partner. He also pointed out that Investec partners with MEFMI in several other activities including the MEFMI Combined Forum.

He pointed out that SWFs are important because many of the countries in the region are endowed with natural resources. However, because these natural resources have not been looked after adequately, many of the countries find it challenging to cater for the populace.

He stated that MEFMI believes that through discussions on the management of wealth from natural resources, through SWFs, countries will begin to manage the wealth from natural resources properly, now and in the future. In the MEFMI region, East African countries have recently discovered oil and natural gases and MEFMI is concerned that the natural resource curse, which was witnessed in some parts of Africa, should be avoided. Thus, this is the right time to start SWF discussions. The Executive Director stressed that MEFMI is not only targeting oil and natural gas, but all natural resources, from copper, to diamonds, gold and coal, which must be carefully looked after.

Mr. Thabo Khojane - Managing Director, Africa Client Group, Investec Asset Management

Mr. Khojane observed that the key to achieve economic diversification in the African region is to set up SWFs and the collaboration between Investec Asset Management and MEFMI will hopefully lead to output around the articulation of the rationale and the role of SWFs as well as a pronunciation of the rule-based frameworks. He also voiced the view that Investec believes that getting these two things right: the rationale and the role of SWFs will lead to sustainable and successful SWFs in the MEFMI region which will lead to economic diversification.

He noted that Investec Asset Management's overarching objective is to support capacity building in the MEFMI region and they believe the partnership with MEFMI has put them in an excellent position to achieve that.

He pointed out that SWF thinking is a first step of a long-term relationship in building capacity in the MEFMI region. Thus far, Investec has worked to benchmark the creation and governance around SWF globally. This framework is currently being shared with numerous countries, including Angola, Botswana, parts of West Africa and increasingly parts of East Africa. Mr. Khojane commended Zimbabwe's decision to embark on the path to create a SWF. He stressed the point that this period of commodity price weakness provides an opportunity for countries to start thinking about building a mechanism that will ensure that in the long run the economies are more diverse.

Dr. John Mangudya, Governor, Reserve Bank of Zimbabwe

Dr. Mangudya underscored that SWFs are important and require the MEFMI region to guard them with the view to enhance economic growth for the region. He said Zimbabwe is a giant in minerals wealth. He noted that natural resources should not only be tapped and extracted but also put to good use for future generations. He pointed out that African countries should learn from those who have done it before as there was no need to reinvent the wheel and the time to start is now.

With regards to the newly established SWF for Zimbabwe, he also stated that the role of the RBZ with regard to SWF is three-fold: to manage funds on behalf of government; to provide advice to the committee or board put in place; and to put in place policies that will sustain the SWF going forward.

He pointed out that SWFs are investment funds that can be tapped into by African governments to widen their resource envelop. Furthermore, they are part and parcel of assets of a country and provide a long term pool of resources that can be utilised by countries to promote long term development. He noted that SWF assets can be invested in other African bonds to enhance the development of Africa. To ensure a balance in investments, SWF assets can be invested both in Africa and offshore.

He pointed out that, ideally there should be a balance between the fiscal space in African countries and development of SWFs, otherwise it is not practical to have SWFs when there is no fiscal space in a country. In other words, African countries must ensure they extract the natural resources, use some of the funds for development, while saving some for future generations. He noted that there should be a balance between what a country spends on development and what it saves which depends on how much weight African governments' place on these components and the resultant equation: Which is more pressing, savings or spending? Ultimately, there should be a balance between these two components. In addition, there should be an African model for transforming economies with the natural resources once they are extracted.

Dr. Mangudya noted that a 30 % saving rate is a sizeable chunk in view of the fact that many African countries do not have huge savings and therefore achieving a 30 % saving rate is a surmountable challenge over a period of time, but not at present.

5. VOTE OF THANKS

Dr. Fundanga, gave a vote thanks in which he expressed his sincere appreciation to all delegates for contributing to the success of the 2015 MEFMI Region Central Bank Governors' Forum. He thanked the Governors and other delegates for participating actively during the discussions. He stated that the intellectual input will contribute immensely in shaping the policy landscape in the MEFMI region.

Dr. Fundanga, singled out the valuable support by the Investec Asset Management as a MEFMI technical and financial partner. Similarly, he thanked the Reserves Advisory Management Programme (RAMP) of the World Bank Treasury, a long-time partner of MEFMI, for sharing their views in this critical area of interest to the MEFMI region.

He also conveyed his sincere appreciation to the BIS for their support, particularly in providing a conducive venue for hosting the event and facilitating travel arrangements for delegates to Basel. He noted that BIS did a lot for MEFMI for the event in the past when the Forum was held as a regular session where BIS was depended upon to assist with arrangements.

He thanked Governor Erkki Liikanen of the Bank of Finland for his attendance. Dr. Fundanga was equally grateful to the Deputy Governor, Bank of Ghana, Dr. Abdul Nashiru Issahaku for attending the Forum. He also expressed gratitude to Deputy Governor Cecilia Skingsley of the Sveriges Riksbank for finding time to join the MEFMI Governors' Forum, noting that the Swiss Central Bank has always cooperated with MEFMI.

Dr. Fundanga noted that the event was the beginning of a long journey in sharing and building the region's capacity to address emerging economic issues and prospects. He assured the delegates that the outcomes of the Forum would be crystallised into a policy paper and disseminated to stakeholders.

Apart from the Forum, he stated that MEFMI was organising the MEFMI Combined Forum which would be held on 6 October 2015 in Lima, Peru where the Ministers of Finance, Central Bank Governors and Treasury Secretaries will be meeting. He indicated that one of the first presentations at the event in Lima would be the report on the Governors' Forum.

6. FORUM LUNCHEON

Lunch for the delegates was hosted by Investec Asset Management at the Les Trois Rois Grande Hotel, in Basel. Guests were addressed by Ms. Katherine Tweedie, Executive Director, Investec Investment Institute. She welcomed all delegates to the lunch, officially launching the MEFMI Region Central Bank Governors Forum in the very special and historic hotel.

She stated that Investec Asset Management felt honoured to be chosen to partner with MEFMI to bring back the important event on the eve of the BIS Annual Meetings. She further pointed out that this was very important for Investec as they look ahead to partnering with MEFMI in other key initiatives including the upcoming events such as the Retreat for Heads of Reserves Management in September 2015 in Luanda, Angola and the Combined Forum in Lima, Peru in October 2015.

She commended the speakers and MEFMI for the selection of the topics of the Forum, noting that these were very important in the context of today's very challenging environment to be giving consideration to the best use of resources in Africa and looking at the long-term goals that best serve the continent.

She pointed out that Investec Asset Management began twenty years ago in South Africa with one client but has grown substantially to its current level, now managing close to US$140 billion funds on behalf of global clients. She noted that in spite of this global growth, Investec has not forgotten the importance of its African roots.

She stated that the complexity of challenges and opportunities faced today, highlights the fact that issues cannot be looked at in isolation; Hence discussions and platforms like the MEFMI Governors' Forum are critical, to have stakeholder engagement that includes the private sector, asset managers, and the World Bank among others.

She underscored that this was one of the reasons why Investec Asset Management decided to launch and build the Investment Institute three years ago. It was critical for Investec to have an independent platform dedicated to long-term research to serve clients that include Central Bank Governors within Africa, pension funds in South Korea and Sovereign Wealth Funds in the Middle East. She pointed out that over the last few years Investec Asset Management has focused its research on the emerging markets for natural resources management and the innovations that are taking place for sustainable investment around the goal settings for MDGs.

She said that Investec had invested considerable amount of time and resources on the question of SWFs management and indicated that the presentation to the MEFMI Central Bank Governors' Forum was the first time that Investec publicly shared the research.

She noted that it was very useful to get feedback and ideas around the additional components that they should be looking at including economic diversification aspects beyond just looking at savings and what is being done to best empower and support the region especially during the challenging times.

She concluded by thanking MEFMI for having Investec as a partner. She pointed out that they have spent the past year doing very detailed analysis on the changes that are taking place in China and noted that China's regulatory environment was changing rapidly, and the research piece that is coming out in September 2015 will be looking at not only the rise of the Renminbi, which is very important when looking at reserves management but also significant opportunities that are opening up in the debt and equity markets in China. She invited delegates to the Investec Institute to share the research on these developments.

7. LESSONS LEARNT AND OUTCOMES, CONCLUSION AND POLICY RECOMMENDATIONS

The key lessons learnt, outcomes and policy recommendations that emerged from the Forum include:

i. It is necessary to establish a rule-based framework and sustainable fiscal rules around natural resources management. Countries should start with a simple rule-based framework which can be effective in terms of the fiscal decisions in the medium and long term. These fiscal rules should tackle both the asset and the liability sides. The rules should be enshrined in national laws in order to be clearly understood by all stakeholders and to protect all stakeholders.

ii. An integrated approach towards savings, spending and stabilisation is essentially a fiscal rule and as such, it falls outside the realm of influence of the Central Bank. However, the Central Bank is in many instances the operational manager of the SWFs and also an important voice in the discussion around sustainable policies in the management of SWFs.

iii. There is no one size fits all. African SWFs will have to determine the right mix of savings, spending and stabilisation which fit their current economic and developmental needs. For other countries, the debate for a savings fund will continue as countries grapple with massive infrastructure and other developmental needs. However, without fail, countries should build a case for the stabilisation and spending fund. Countries should note that SWFs are a work in progress and their mandates and structures continue to evolve over time and get clarified and strengthened.

iv. African countries considering a savings fund should consider savings policies in the region of 25% if institutional capacity to spend on the right projects is appropriate.

v. African countries, with massive infrastructure and development needs, can consider a model where specific investment needs have specific fund names like hospital fund, public education fund, highways fund, etc. Thereafter, funds are specifically earmarked in the budget to these particular and priority items. It is also a good and effective way to create public and political buy-in towards these funds.

vi. For Africa, this is the right time to get the house in order as it takes approximately ten years from the point of legislation initiation to the point where the SWFs are capitalized. Most African countries have talked SAWFs for about three years now. Thus there are approximately eight years to prepare the SWFs for the next resource boom.

vii. There is cost to delayed set-up and implementation of SWFs, not just institutional adjustment costs, but also the cost of depleting reserves. In addition, as reserves are depleted, there is loss of earning power which would have been generated by those assets.

viii. The pros and cons between the Central Bank and independent asset management institutions is that there are no clear answers. There are benefits and shortcomings in each category. It was recognised that Central Banks have the advantage of accumulated experience, firstly being independent institutions from government, secondly, with technical capacity, and thirdly, having a predominant culture of capital preservation in the investment decisions. This corporate culture plays quite a significant role where Central Banks tend to manage assets more conservatively than other entities when given the leeway to generate long-term return.

ix. Human resource policies must be strengthened to allow for attraction and retention of skilled staff in SWFs.

x. The principles of segregation of duties and institution autonomy are important. This should include clear segregation of duties among the principle and agent. This includes the clear roles of Central Banks and external fund managers on one hand and the principle which is the ministry of finance and parliament on the other.

xi. The importance of citizen and political consensus in a country to generate buy-in is also critical.

8. FORUM PROGRAMME

MEFMI REGION CENTRAL BANK GOVERNORS' FORUM
SATURDAY 27TH JUNE 2015
BASEL-SWITZERLAND

<u>Theme:</u> Leveraging Sovereign Wealth Funds as a Tool for Economic Stabilisation

Time	*Event*	*Speaker/Presenter*	*Moderator*
0830– 0900 hours	***Registration***		***MEFMI***
OPENING ***0900 – 0930 hours***	***Welcome Remarks***	**Dr. Caleb M. Fundanga,** *Executive Director, MEFMI*	
	Remarks by Investec Asset Management	**Mr. Thabo Khojane,** *Managing Director, Africa Client Group, Investec Asset Management*	
	Official Opening	**Dr. Adelaide R. Matlanyane** *Governor, Reserve Bank of Zimbabwe*	
0930 – 1000 hours	**Presentation:** *Why the Recent Slump in Commodity Prices Strengthens the Case for African SWFs, Fiscal Rules and Good Governance.*	**Mr. Malan Rietveld,** *Investment Institute, Investec Asset Management*	**Mr. Patrick Mutimba**, *MEFMI*
1000 – 1030 hours	***Discussion***	**All**	
1030 – 1045 hours	**Health Break**		
1045– 1115 hours	**Presentation:** *Role of Central Banks in Managing a Country's Natural Resource Revenues: Investment and Institutional Considerations.*	**Dr. Ekaterina Gratcheva,** *Lead Financial Officer, World Bank Treasury, RAMP*	**Dr. Sehliselo Mpofu**, *MEFMI*
1115 – 1145 hours	***Discussion***	**All**	
1300– 1430 hours	**LUNCH AND GROUP PHOTOGRAPH**		

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