Macroeconomic and Financial Management Institute of Eastern and Southern Africa

REPORT OF THE PROCEEDINGS OF THE 2015

MEFMI COMBINED FORUM

FOR MINISTERS OF FINANCE AND/OR OF ECONOMIC PLANNING, SECRETARIES OF FINANCE AND / OR OF ECONOMIC PLANNING AND CENTRAL BANK GOVERNORS

LEVERAGING SOVEREIGN WEALTH FUNDS AS A TOOL FOR ECONOMIC TRANSFORMATION

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LIST OF ACRONYMS

ACBF	African Capacity Building Foundation
AFREXIM	African Export-Import Bank
AfDB	African Development Bank
BIS	Bank for International Settlements
BEPS	Base Erosion and profit Shifting
EAC	East African Community
EITI	Extractive Industries Transparency Initiative
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Countries
IFSWF	International Forum of Sovereign Wealth Funds
IMF	International Monetary Fund
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
MOU	Memorandum of Understanding
OECD	Organization for Economic Co-operation and Development
PPP	Public Private Partnerships
RAMP	Reserves Advisory Management Programme
SDR	IMF Special Drawing Rights
SSA	Sub Sahara Africa
SWFs	Sovereign Wealth Funds
SMEs	Small and Medium Enterprises
UNECA	United Nations Economic Commission for Africa
WAEFEM	West African Institute for Financial and Economic Management

FOREWORD

The MEFMI Combined Forum is a premier annual event conducted by MEFMI. It is conveniently scheduled to run back to back with the World Bank/IMF Annual Meetings. The Combined Forum targets Ministers of Finance and/or Economic Planning, Secretaries of Finance and of Planning and Central Bank Governors.

MEFMI collaborates with its private partners; that is, Investec and EY to jointly fund and deliver the event which has become very popular amongst policy makers from the MEFMI region as well as international cooperating partners. The Combined Forum also brings together international organisations who participate in the delivery of technical sessions while others attend as observers. Some of the technical and financial cooperating partners who attended the 2015 Combined Forum are the World Bank, the International Monetary Fund, the African Development Bank, African Capacity Building Foundation, Standard Chartered Bank and the AFREXIM Bank, among others.

The 2015 Combined Forum was held on the 6th of October 2015 in Lima, Peru. It was attended by 113 delegates comprising high level officials from MEFMI member states, non-MEFMI member states, MEFMI financial and technical cooperating partners, private sector sponsors, members of the media and some Secretariat staff. This was one of the best attended Combined Forum, with diverse delegates since the inception of MEFMI 21 years ago.

The theme of the 2015 Combined Forum was ***Leveraging Sovereign Wealth Funds as a Tool for Economic Transformation***. This was a build-up from the 2015 MEFMI Governors' Forum on the same theme which was held in July 2015 in Basel, Switzerland on the side-lines of the BIS Annual Meetings.

It is MEFMI tradition to synthesize policy discussions and outcomes from high level fora into detailed reports. The reports do not only preserve the stock of intellectual output from these very insightful activities, but the information is also disseminated to all stakeholders and can be used as reference material.

This report synthesises the deliberations and policy discussions during the Forum. As the Institute plans for the next event in 2016, feedback is welcome in order to assist in further refining the documented lessons to ensure that the Combined Forum remains appropriate and applicable to the region.

The Institute wishes to convey its sincere gratitude to EY and Investec Asset Management, for their continued financial support towards hosting the Combined Forum. Gratitude is also extended to all technical partners as well as the invited guests, for contributing in different ways to the success of the 2015 MEFMI Combined Forum.

Caleb M. Fundanga
MEFMI Executive Director

1. WELCOME AND OPENING SESSION

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

Dr. Fundanga welcomed all stakeholders and invited guests to the 2015 Combined Forum. These included Honourable Ministers, Central Bank Governors, Permanent Secretaries, officials from EY and Investec Investment Institute. He also welcomed the Vice President and Treasurer of the World Bank, the Executive Secretary of ACBF, the representative of the President of African Export and Import Bank as well as representatives of the donor community.

He pointed out that the Combined Forum was a unique platform that provided delegates an opportunity to share experiences and receive views from experts and colleagues from other regions on critical issues of relevance to the MEFMI region.

Dr. Fundanga expressed his gratitude to the Honourable Ministers, Permanent Secretaries, Governors and other distinguished guests for accepting MEFMI's invitation to participate in the 2015 MEFMI Combined Forum. He also expressed his gratitude to EY and Investec Asset Management, who have grown to be regular financial and technical partners for the Combined Forum. He stated that the support received from the private sector partners had also extended to other regional capacity building events conducted by the Institute. The relationship with the two (2) private sector partners, particularly for the Combined Forum had strengthened over the years and their input enriched the deliberations.

Similarly, he thanked the Reserves Advisory Management Programme (RAMP) of the World Bank Treasury for its continued support towards MEFMI's programmes and participation in the MEFMI Forum.

He extended a warm welcome to the speakers for the event namely; Mrs Linah K. Mohohlo, the Governor of the Central Bank of Botswana and the chairperson of the MEFMI Executive Committee; Ms Arunma Oteh; the Treasurer and Vice President of the World Bank; Dr. Ekaterina Gratcheva and Mr. Bernard Murira of the RAMP at the World Bank Treasury; Mr. Malan Rietveld from the Investment Institute of Investec Asset Management; Mr. Charles S. Makola a Partner -International Tax & Tax Policy, Africa at EY; and Dr. Philliph O. Kamau, the representative of the President of African Export-Import Bank (AFREXIM).

Dr. Fundanga also welcomed session panelists, Professor Emmanuel Nnadozie, from the ACBF, Mr. Kristian Flyvholm, from the International Forum of Sovereign Wealth Funds (IFSWF), Mr. Malan Rietveld, Director for Investec and Mr. Jukka Pihlman, Managing Director, Head, Central Banks & Sovereign Wealth Funds (SWFs) Public Sector and Development Organizations.

He highlighted the main discussion topics for presentation and discussion as:

- Transforming Depleting Natural Resources into Income for Growth;
- Taxation of Natural Resources: Principles and Policy Issues;
- Sovereign Wealth Fund Management: The Case of Botswana; and
- Managing Africa's Revenues: In search of Stability and Diversification.

He pointed out that these topics were an extension of the in-depth deliberations of the 2015 MEFMI Region Central Banks Governors' Forum which was held in Basel, Switzerland in June 2015. He informed delegates that the deliberations during the Governors' Forum confirmed that Africa and the MEFMI region is richly endowed with natural resources. He added that natural resources, even in their abundance can get depleted and therefore it is incumbent upon the region to contribute towards prudent management of revenue from natural resources, and fully exploit their potential to contribute to economic transformation of the MEFMI region.

He stated that many MEFMI countries including Angola, Botswana, Mozambique, Namibia and Zambia generate substantial export revenue from natural resources extraction while others like Kenya, Tanzania and Uganda will soon become exporters of gas and oil.

Dr. Fundanga emphasised that it was important to increasingly build capacity and share knowledge in this area. He stated that he recognized the fact that countries in the region have competing priorities and were faced with the dilemma of where, when and how much to invest using the available resources. Furthermore, with huge infrastructure gaps and investment needs, countries were hard pressed to apply resources to achieve this development agenda and industrialization while also saving for future generations and stabilizing current budgets.

Dr. Fundanga stated that it was his strong belief that the 2015 Combined Forum would influence positive change for the benefit of the region.

1.2 Key Note Address by Senator Martin Dlamini, Minister of Finance, Kingdom of Swaziland

Senator Dlamini, who is also the Minister of Finance for the Kingdom of Swaziland officially opened the 2015 Combined Forum.

Honourable Dlamini extended a special welcome to officials who were attending the event for the first time and pointed out that they were certain to find the diversity of thoughts and the rich debate that characterized the Forum, enriching. He reiterated the importance of private sector partners in mounting high level events such as the Combined Forum. He thanked Ernst & Young and Investec for being financial partners for the event.

He pointed out that the MEFMI region had witnessed significant progress since the formation of the Institute in 1994. He added that this included improvements in macroeconomic and financial sector management, reduction in external indebtedness through the Heavily Indebted Poor Countries (HIPC) initiative, accumulation and management of reserves, and discovery of new deposits of natural resources, particularly oil and gas in a number of MEFMI member countries.

He stated that there was improved human and institutional capacity in macroeconomic and financial management across the region. These improvements were attributed to the significant role that MEFMI played in client institutions over the past 21 years. However, despite these achievements, new challenges still remained in the MEFMI region, which prohibited the attainment of the shared goals of economic growth and poverty reduction. For instance, subsequent to obtaining new laws in Debt/GDP ratios, many countries were subjected to sovereign credit rating and started accessing the international bond markets. He added that this trend has led to the new rise of debt levels in some countries. He highlighted that countries operate in an environment where attainment of economic growth is determined by the tenacity in formulating and implementing appropriate national policies in response to dynamic regional and international developments.

Honourable Dlamini pointed out that the theme for the 2015 Combined Forum was very pertinent for the region, considering the numerous constraints to economic growth and development being faced by member countries while exploring the emerging opportunities such as the discovery of natural resources.

While reflecting on the topics to be discussed during the Forum, Senator Dlamini highlighted that over the past five (5) years, MEFMI member countries had made additional discoveries of natural resources. These included oil, gas, diamonds, gold, copper, and uranium. He pointed out that these new discoveries were expected to propel MEFMI member states to become the world's resource-based economic growth frontier, in the medium to the long-term, while broadening fiscal space and providing opportunities to address poverty. He noted that these aspirations were not guaranteed due, in part, to the following: inadequate capacity in managing natural resources in the region, specifically on contract negotiation, taxation of natural resources, and establishment and management of SWFs. Furthermore, the finite nature of natural resources, which without proper investment and management, would disadvantage future generations.

He noted that he was aware of many studies conducted regarding the management of natural resources. However, not many of them provided concrete direction for the region, particularly the policy framework/institutions in the macroeconomic and financial sector, to manage the revenue accruing from natural resources.

He quoted Professor Joseph E. Stiglitz statement that, *"It appears that, on average, resource-rich countries have performed worse than those with smaller endowments. But not all resource-rich countries have fared the same. Some 30 years ago, Indonesia and Nigeria had comparable per capita incomes, and both were heavily dependent on oil revenues. Today, Indonesia's per capita income is four times that of Nigeria. Both Sierra Leone and Botswana are rich in diamonds. Botswana has had an average growth rate of 5.2 percent between 1974 and 2002, but Sierra Leone has plunged into civil strife over control of its diamond riches. But even when countries as a whole have done fairly well, resource-rich countries are often marked by large inequality, poverty, war insurgence and illiteracy amongst others"* (From Resource Curse to Blessing, by Joseph E. Stiglitz, August 6, 2012 at //www0.gsb.columbia.edu/faculty/jstiglitz/download/papers/2005_Covering_Oil.pdf).

Senator Dlamini expressed hope that by the end of the Forum, delegates would have shared, in great depth, the possible solutions to those issues that confront the region in relation to managing revenue from natural resources. He noted that he had no doubt that the Forum would make significant contribution towards realising MEFMI's mandate of enhancing economic management capacity in the region and enabling the economies to address their numerous socio-economic challenges.

2. FORUM PRESENTATIONS AND DISCUSSIONS

2.1 SESSION 1: ROLE OF LEADERSHIP IN THE MANAGEMENT OF NATURAL RESOURCE REVENUES IN AFRICA

This presentation was made by Ms. Arunma Oteh[1] and moderated by Honourable Patrick Chinamasa, Minister of Finance and Economic Development for Zimbabwe.

Ms Oteh underscored the need for the MEFMI region to put into context the current situation of the Africa region with regards to the management of natural resource wealth. She noted that in the recent past policy makers from the Africa region had adopted Sustainable Development Goals. She said that while these were viewed by many as ambitious, the delegates at the Combined Forum should be aware that as leaders, the citizenry would be expecting that over the next 15 years, the goals would be achieved. She also mentioned that the Africa region had to a great extent, managed to weather the global financial crises. As such, it was important for the region to focus on the second generation of reforms which she referred to as enablers; These are investments in education, health, and infrastructure. She stated that in Nigeria, it was estimated that over the next 30 years, the country would need over US$3.9 trillion for infrastructure development alone. This would most likely be funded by revenue that would be derived mainly from natural resources. She cautioned policy makers not to be overly dependent on natural resource wealth as the new discovery of natural resource deposits was likely to cause a decline in market prices for the same. In this regard, she underscored the need to effectively manage natural resources wealth.

Also of great concern to policy makers should be the skills gap, which Africa should address urgently. She also implored policy makers to pay attention to the security challenges that come from the inequality associated with access to natural resources.

Ms Oteh stated that SWFs are important for managing revenue from natural resources. In 1952, Saudi Arabia and Kuwait started the concept of SWFs, followed by Norway in

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[1]Ms. Arunma Oteh is the newly appointed Treasurer and Vice President of the World Bank. Ms Oteh manages and leads a large and diverse team responsible for managing more than $150 billion in assets. Amongst her major responsibilities, Ms Oteh engages with outside stakeholders including global private sector financial institutions, the financial media and the sovereign debt and reserves managers in client countries, as well as rating agencies. Prior to joining the World Bank, she was the Director General of the Securities and Exchange Commission of Nigeria. Appointed to a five-year term by the President of Nigeria in 2010, she led the transformation of the country's capital markets industry into a major global presence. She was a member of the Board of the International Organization of SecuritiesCommissions (IOSCO) and the Chairperson of the Africa Middle East Regional Committee of IOSCO. Prior to joining the Securities and Exchange Commission (SEC) of Nigeria, Ms Oteh was Group Vice President, Corporate Services, at the African Development Bank Group (AfDB). In this role she oversaw a number of departments, including human resources, information and communications technology, and institutional procurement. From 2001 to 2006 she held the role of AfDB Group Treasurer, where she led AfDB's fundraising and capital market activities across the world. Earlier roles at the AfDB, which she joined in 1992, included trading room management, investment portfolio coverage, and public sector lending. She also held other positions in capital markets and lending during the course of her career at the AfDB. Ms Oteh began her career in 1985 at Centre Point, where she executed debt and equity offerings in the Nigerian capital markets. She earned her Bachelor of Science in Computer Science from the University of Nigeria and her Masters of Business Administration from Harvard University.

the 1990s. In the region, Botswana was one of the first countries to establish a SWF in the 2000s, and more recently Angola and Nigeria. Her research revealed that assets valued at more than US$7.7 trillion - an amount that had doubled in the last four years - are under the management of SWFs. This on its own had increased the level of awareness on the importance of SWFs amongst policy makers. SWFs are critical in stabilization, saving resources for future generations and more recently resource rich countries are setting aside resources to focus on development in the domestic economy.

She noted that one of the things that she greatly appreciates about natural resources management, whether it is the Extractive Industries Transparency Initiative (EITI) or the Santiago Principle is that each of these have been brought together by consensus and so the frameworks of governance and transparency for managing resources exists. She stated that in terms of EITI compliant countries such as Mozambique, Tanzania and Zambia are already leading as they are openly disclosing information on contracts, licenses, production and other elements around resources extraction. She underscored transparency as a fundamental pillar of accountability and effective management of natural resources.

In terms of the Santiago Principle, she stated that what was fascinating was that they recently combined forces of the diverse sets of SWFs across countries, income levels and integrated decades of experience. The Santiago Principle has therefore set up practice of overall governance. She pointed out that she found the following key policy considerations important in the management of natural resources: *building the governance framework for checks and balances*; *fostering broad national consensus on strategic objectives through national dialogue across stakeholder communities*; and *integrating their voices in the overall policy*. Thus, building trust was particularly critical in natural resources management.

She further stated that what was critical for each natural resource rich country was translating strategic objectives into fiscal rules to govern sustainable budgetary spending for infrastructure and social needs. It was also critical to ensure that countries generate savings to cushion the impact of commodity price swings, avoiding inefficient investment, preventing excessive appreciation of currencies and allowing for inter-generational finance. She underscored the importance of delegating the implementation of these strategies to specialists and experts. She also pointed out that it was imperative to allow flexibility for the overall policy to adjust in line with evolving visions, domestically and globally.

She added that countries have to embrace the EITI and the Santiago Principle as they provided countries with frameworks. What is of great necessity is for countries to implement the frameworks and principles. Citing Kiribati and Nauru, Ms Oteh noted that these two countries are some of the smallest in the world with similar histories. Both were endowed with phosphates which have since been depleted. The two countries both set-up SWFs in 1979. Today Kiribati has a fund which is 400% of its GDP and income from the fund provides approximately 45% of its annual budget. Nauru on the other hand, ran down its fund due to mismanagement. She also mentioned East Timor which was associated with conflict. In 2003, the country set up a SWF which allows them to meet some of their domestic investment needs such as infrastructure. She stated that notwithstanding the Santiago Principle or EITI, she wanted delegates to appreciate the important role that policy makers play in ensuring that principles are implemented. She stated the importance of visionary leadership as very important as this played a major role in balancing immediate and future needs. She said as leaders, the delegates had to also keep in mind an African proverb; "***A society grows when leaders plant trees whose shades they will never sit under them."***

She further stated that for the countries that are not already on SWFs path, the time was now. She encouraged MEFMI member countries to adhere to the principles and guidelines as these would enhance transparency and accountability amongst other issues. She also appealed to the delegates to ensure that relevant staff received adequate training and cited the World Bank RAMP / MEFMI technical workshop planned for May 2016 in Kampala, Uganda.

2.2 NATURAL RESOURCE WEALTH MANAGEMENT: HIGHLIGHTS FROM THE 2015 MEFMI REGION CENTRAL BANK GOVERNORS' FORUM

This session was presented by Dr. Caleb M. Fundanga and chaired by Honourable Patrick Chinamasa. The presentation provided highlights of the 2015 MEFMI region Central Bank Governor's Forum which was held in Basel, Switzerland on the sidelines of the Bank of International Settlement (BIS) Annual General Meeting. He pointed out that this was a re-launch of the Forum after being suspended ten (10) years ago. The Forum allows Central Bank Governors to meet and share issues of policy relevance to the region. The Theme of the 2015 Forum was ***Leveraging Sovereign Wealth Funds as a Tool for Economic Stabilisation***. Dr. Fundanga stated that this was the first event of the newly introduced programme on Natural Resource Management Capacity Building Programme (NRM-CBP).

He informed delegates that the Governors' Forum was opened by Dr. Adelaide Matlanyane, Governor, Central Bank of Lesotho and attended by MEFMI Governors and invited officials from within and outside the MEFMI region. He noted that MEFMI was privilaged to have other distinguished delegates during the Forum such as the Governor of the Bank of Finland, the Deputy Governor of the Swiss Central Bank, the Deputy Governor of the Ghanaian Central Bank, stating that the idea was to interact with as many colleagues as possible. The event was also attended by the General Manager of the BIS who also offered MEFMI the facilitities at the BIS headquarters.

Dr. Fundanga stated that the Governors' Forum was jointly funded by MEFMI and Investec Asset Management who delivered a presentation at the meeting entitled ***Why the Recent Slump in Commodity Prices Strengthens the Case for African SWFs, Fiscal Rules and Good Governance.*** The World Bank RAMP made a presentation entitled ***The Role of Central Banks in Managing a Country's Natural Resource Revenue: investment and institutional considerations.***

He outlined key policy takeaways from the Forum as follows:

i. **Resource Abundance:** Africa has an abundance of barely harnessed natural resources with Angola, Nigeria, Egypt, Cameroon, being oil producers and Kenya, Mozambique, Uganda and Tanzania to be first time oil and gas producers. Copper in Zambia and the Katanga region in the DRC; Diamonds in Botswana, Angola, Namibia and Lesotho; Gold in Zimbabwe, South Africa and Swaziland.

   He stated that these natural resources are finite and will be depleted at some point and therefore, the key question is how the region should plan to survive when resources are depleted.

ii. **Revenue Management Model:** Revenue from natural resources requires prudent management to achieve three (3) important goals: firstly; developmental goals of growth and poverty reduction, secondly; allow for inter-generational wealth transfers as they risk having nothing because of current actions, and thirdly; for economic stabilization due to volatile prices.

   He pointed out that these objectives can be achieved through the establishment of a Special Purpose Vehicle (SPV) or SWF. However, he cautioned that SWFs are not a panacea for growth and development, and all problems.

iii. **Rules-Based SWF Framework:** If countries are to establish SWFs, it would be useful that they develop rule-based frameworks. He highlighted that countries should start with simple rule-based frameworks which can be effective in terms of the fiscal decisions in the short to medium term. In the medium to long term, countries could adopt a more co-integrated, fully-fledged, rule-based framework. The rules should be enshrined in the law to be clearly understood and to protect all stakeholders. SWFs are work in progress and their mandate and structures evolve over time as they get clarified and strengthened.

   Dr. Fundanga stated that he led a delegation from Zimbabwe on a week-long study tour to Norway, in order to get insights on best practice of managing natural resources. He pointed out that Norway has clear policy and consensus on a lot of issues such as how the wealth is to be taxed, how the money is spent, how it is invested, and how much goes into the annual budget. He further noted that in Norway, political changes have no effect on policies, unlike in most MEFMI member countries.

   He stated that this was the kind of stability countries need so that investors in natural resources know that they will be facing a clear tax regime for over 20 to 30 years. Even in a country with a stringent tax regime, they will be able to estimate the return on investment because of policy stability. He underscored the importance of agreements on what should be done to ensure stability and avoid tax regime changes that usually come with change of governments in Africa.

iv. **Role of Sovereign Wealth Funds:** He noted that rule-based SWFs help stabilize volatile revenue, particularly given volatile prices as indicated by current trends in oil prices.

He added that this helps countries to smoothen revenues in times of low and high prices. They also support domestic infrastructure development, which is a high priority in most African countries. He noted that currently in the MEFMI region electricity is in short supply, given load shading lasting for half or two thirds of a day. He noted that proper use of SWFs can allow for building infrastructure such as railways and roads. Furthermore, through spending rules, countries can transform depleting volatile natural resources into more stable permanent financial assets which can be invested anywhere in the world and remain available even after resources have been depleted.

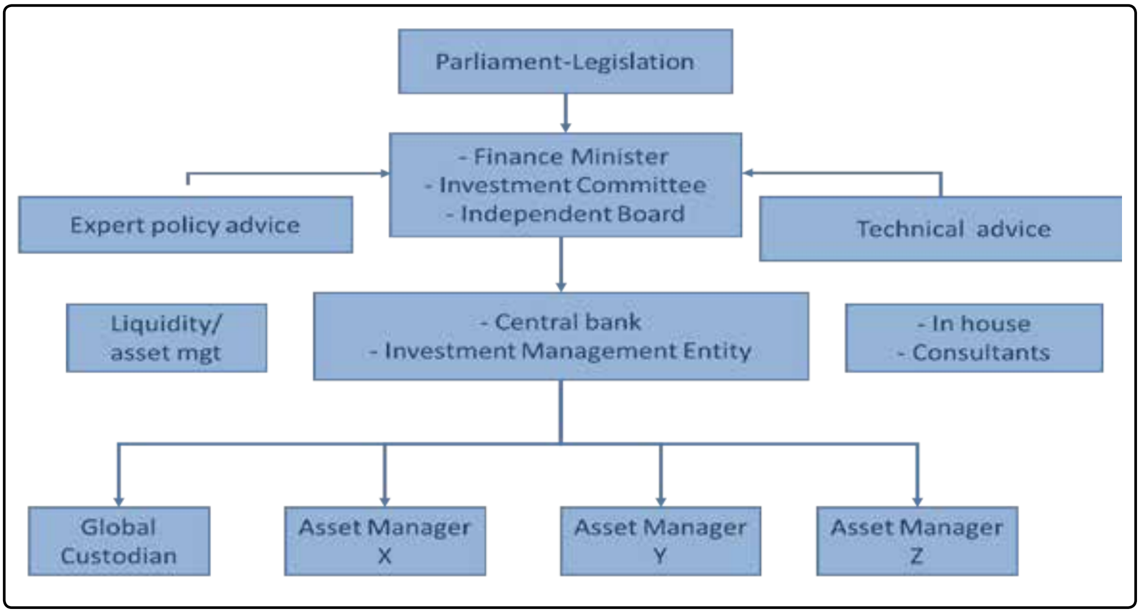
With regards to the Development Model, he argued that African countries have massive infrastructure and other development needs. Consideration is taken of a model where specific priority investment needs have specific funds such as hospital fund, public education fund, highway roads fund, etc. Thereafter, resources are specifically earmarked in the budget to these priority areas. In this model, countries are free to choose what they want to do. In some countries the construction of a highway can be more important while another country may put priority in education hence they can apportion their money for that purpose.

v. On **customized solutions**, Dr. Fundanga emphasized that there was no one size fits all. The right mix of stabilization, spending and savings depends on a country's overall economic and developmental needs. For African countries developing a savings fund, savings of approximately 25% may be considered. This fund should go hand in hand with appropriate institutional capacity for spending. He emphasized that most of the time when African countries get a windfall they get into extravagant spending mode, which does not benefit the majority. In this regard, how to spend the money is very critical. Appropriate institutional capacity for spending wealth is therefore absolutely important.

Key Considerations:

- **Segregation of duties and institutional autonomy** are important between the principal and the agent as indicated in **Chart 1** below. SWFs have to be effectively and efficiently managed. Generally, there are various roles but do we have trained staff to manage the assets and make the critical decisions? Parliament passes legislation which ensures proper management. Experts within the Ministry of Finance provide policy advice while others provide technical advice. The role of the Central Bank is important as the investment management entity. Asset management might be delegated to private asset managers leaving some responsibilities to in-house managers.

Chart 1: Segregation of roles and Governance Structure: How different SWFs have managed their governance and institutional arrangements



- **Oversight** issues are also critical and must be considered to ensure transparency.

- **Control and oversight** roles are also key - in cases of difficult investment decisions and challenges to governance.

- **Transparency and communication** – different interested parties and stakeholders must buy into the country's concept of having a sovereign wealth fund.

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

- It is critical to generate political **buy-in and consensus** from the citizens.

The Case for the Central Bank:

Dr. Fundanga noted that there are divergent arguments with some arguing that Central Banks must be the managers while others argue for independent managers. There are **pros and cons** of having either the Central Bank or an independent entity as asset managers for the SWFs. Central Banks have the advantage of:

- Being independent from government;
- Having technical capacity in investment management;
- Having a predominant culture of capital preservation;
- Having special privileges and immunities; and
- Legitimacy in international financial markets.

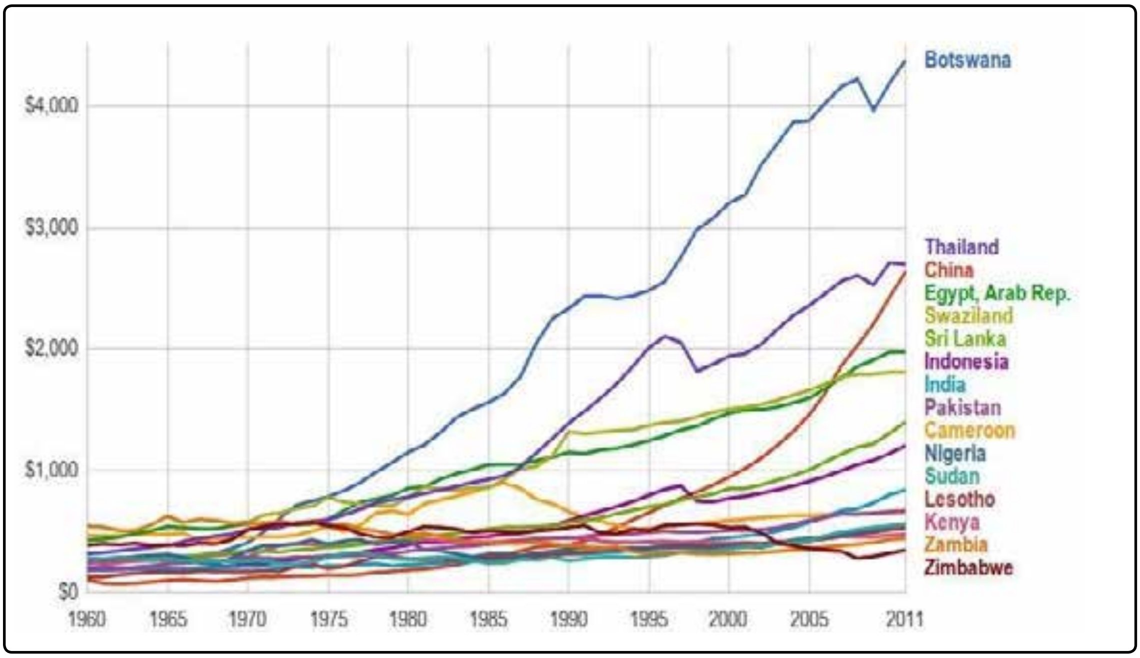
The Case for Independent Asset Managers:

- Independent external asset managers provide a clean slate to implement the best and most contemporary best practices;
- An independent entity is not subject to public sector regulation, thus the human resource policies would not be constrained and would be able to offer competitive packages; and
- However, legal issues may be challenging particularly with regards to immunity and succession for these institutions.

Need For Early Reforms:

- The cost of delayed reforms - there are costs to delayed set-up and implementation of SWFs. Not just institutional adjustment costs, but also the cost of depleting reserves which is associated with loss of earning power which would have been generated by those assets.
- **Chart 2** below shows Botswana, as a good example where growth in per capita GDP has out-performed China, Indonesia, India, Thailand and other economies in the world, following prudent natural resource wealth management.

Chart 2: GDP per capita (constant 2000 US$)



Concluding Remarks

Dr. Fundanga concluded the highlights of the Governors' Forum by emphasizing that the strong economic performance even when commodity prices have slumped, are signs that Africa is making progress on growth and poverty reduction through:

- Economic diversification from single or few commodities;

- A number of countries are redirecting a huge portion of resources for inclusive and equitable growth. He noted that in terms of global economic performance, Asia comes first followed by sub-Saharan Africa within which the MEFMI region is leading. The reason is partly due to economic management that has improved and can be rightly attributed to MEFMI, which has contributed to this progress through capacity building in macroeconomic management. He underscored that there is evidence that countries are managing their economies properly and more can be done to ensure that prudent economic management continues in our region; and

- The slump in international commodity prices is an opportunity for countries to lay the foundation for the establishment and management of SWFs as they prepare to take advantage of the expected future rise in commodity prices and the resultant boom.

2.3 SESSION 2: TRANSFORMING DEPLETING NATURAL RESOURCES INTO INCOME FOR GROWTH

This presentation was made by Mr. Bernard Murira[2] from the World Bank, RAMP and chaired by Honourable Claver Gatete, Minister of Finance and Economic Planning, Rwanda.

Honourable Claver Gatete highlighted that there is need for countries to determine how financial resources from natural resources should be managed and allocated. He pointed out that with resource managers available at central banks and in international organisations, it was crucial for countries to put in place clear and transparent rules and regulations to ensure maximum benefit for current and future generations. He also indicated that such regulations should not be affected by change of government or

[2]Mr. Bernard Murira is a Lead Financial Officer in the Financial Advisory and Banking Department at the World Bank Treasury. He has been at the World Bank for the past 18 years, and has broad based investment management experience with the World Bank Treasury, where he works with various global central banks and other official institutions as an Engagement Manager responsible for co-ordinating their technical advisory engagements with the World Bank Treasury under the Reserves Advisory and Management Program (RAMP). He works with these official institutions in developing their governance structures, including the investment policies and strategic asset allocation (SAA). In addition he is working with these institutions in developing appropriate organization structures, as well as in implementing operational frameworks for the efficient management of reserves portfolios. Bernard has also worked on RAMP secondment to the South African Reserve Bank from 2009 to 2012, supporting the SARB's foreign currency reserves management. Prior to his current engagement, he was co-managing the Risk and Analytics team at the World Bank Treasury, responsible for the risk and performance measurement and reporting as well as compliance monitoring for the assets managed by the World Bank Treasury. Prior to joining the World Bank he worked at the European Corporate Treasury team at Price Waterhouse in London providing corporate treasury advisory services to large UK multinationals. He holds a Master of Science in Finance from George Washington University, and an MBA from Cranfield University School of Management. He is also a CFA charter holder and a Certified Public Accountant.

change of office bearers in government institutions. He applauded World Bank RAMP for the work they have done in this area for the National Bank of Rwanda.

He stated that good management enables countries to avoid the problem that was faced by one of the Governors from the Bank of Malaysia, where the Government wanted to utilise a large chunk of resources from natural resources managed by the Bank. To mitigate this problem, the Governor hired an expert to provide technical advice on how to manage the demands of government. The policy advice given was applied resulting in the government not utilising the financial resources from the natural resources.

In his presentation, Mr. Murira pointed out that it was important to have the appropriate framework to be able to transform the resources in a sustainable manner. His presentation focused on the policy choices on how to split between spending now through the fiscal budget and being able to save for the future and how to transform it into prosperity.

He highlighted three (3) key questions that his presentation focused on;

a. *What are the appropriate governance and policy frameworks that are necessary in order to ensure maximum value added from the exploitation of natural resources wealth, so as to avoid the boom and bust cycles given the high volatility of commodity prices*?

b. *What are the principles guiding the spending of the commodity revenue efficiently*? *What are the fiscal frameworks, fiscal targets and fiscal rules*? *How do we frame the choices that exist in terms of managing available resources in order to have sustainable fiscal spending and also to be able to save for future generations*?

c. *What is best practice at institutional level and governance arrangements that are useful and important for guiding the successful set up of long term savings funds across countries*?

He identified three (3) topics to address the above questions as follows:

A. Key challenges for commodity countries
B. Policy choices in response to the challenges
C. Institutional arrangements for managing long term savings

A. HIGHLIGHTS OF THE KEY CHALLENGES FOR COMMODITY COUNTRIES

Mr. Murira pointed out that the key challenges that are faced by commodity countries are imperative in setting the framework on making choices and on how to use revenue, followed by choices regarding spending on the fiscal side and how to support the domestic sector - the non-resource sector of the economy.

Asset Transformation – From Natural Resources to Growth
He pointed out that countries which are endowed with natural resources would want to turn the revenue into products and services for citizens including better health, better

education, better infrastructure and access to good quality life. This involves movement from the resource side to the sustainable space.

Using the baobab tree as an example, he explained that the tree is common in Africa and other parts of the world. It stores a lot of water during the rainy season up to 100,000 litres for use during the dry season. Based on the same analogy, countries should move from the revenue space to a space that is sustainable for nations now and for future generations.

Sequencing
The process of sequencing starts from the discovery, moving to monetization of resources from the ground to exportable commodities. This is followed by various arrangements including taxation, production sharing, fees and taxation from which governments generate revenue.

On human capital, he stated that the question is how public policy can contribute to the acceleration of human capital. He emphasized that human capital is the biggest investment that governments can build for current and future generations; thus, countries must transform the natural resources for sustainable growth.

Key Policy Challenges for Net Commodity Exporters
Countries that are highly dependent on the export of commodities are exposed to three (3) key policy challenges:

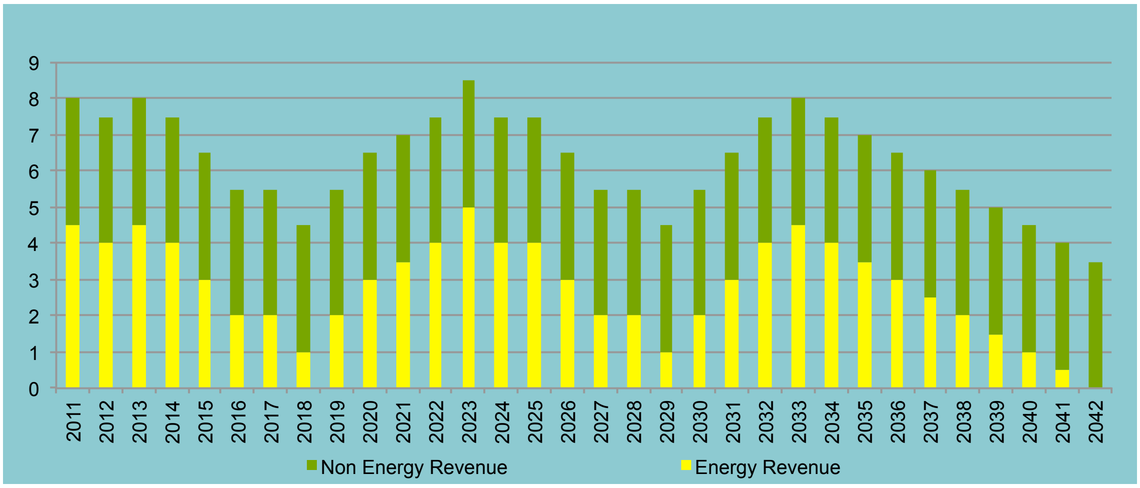
- Stabilization to avoid boom and bust cycles given the high volatility of commodity prices. Commodity revenues are very volatile;

- Saving for future generations and/or to generate alternative sources of income different from non-renewable resources; and

- Spending commodity revenue efficiently: balance between investing in today's needs vs. building a portfolio of financial assets.

In Chart 3 below, the yellow bars depict volatile commodity revenue while the green bars depict non-energy revenue or fiscal revenue. If governments spend as they earn revenue, then they face pro-cyclical revenue. That is, when revenue declines, countries spend less yet they are actually supposed to spend more.

Chart 3: Government Budget (US$ Billion)



Source: World Bank

This is the spending scenario that needs to be avoided or smoothed out to be sustainable. The question is therefore how policy mechanism is put in place to be able to figure out how much of the revenue received should be spent and how much is saved.

The other important component is to be able to transform the resource revenue to non-resource revenue that will be able to diversify the economy and to be able to invest for current needs and in financial assets that diversify the economy and ensure intergenerational equity between current and future generations.

B. POLICY CHOICES IN RESPONSE TO THE CHALLENGES

There are numerous options with regards to policy choices that can be adopted as well as challenges related to estimating the commodity revenue. This is mainly because there are a lot of variables including those relating to quantity of resources as well as their prices. There is also a challenge of estimating the size of the commodity and non-commodity revenue.

The volatility in energy prices in the last few years highlights the big challenge associated with the variables related to exploiting the resources and developing the infrastructure that is necessary to enable countries undertake resource exploitation. There is also a challenge in estimating the amount and the timing of the receipt of revenue from natural resources.

After estimating revenue, the biggest challenge is utilisation or deployment. There are many considerations in this respect including the absorption capacity of the economy. If, for example, funds flood the economy, it might result in the Dutch disease which destroys the non-resource sectors. It can also be inflationary or result in the appreciation of currency.

Achieving Consensus on the Use of Revenue - Hardest Challenge

The decision on how much to spend or save involves a difficult decision at the national level and depends on:

- ✓ The size of projected revenue: Non-commodity and commodity revenue (total expected production* long term price assumption); and

- ✓ The deployment of revenue for the purposes of stabilization, saving and spending to promote long term fiscal stability based on the analysis of many variables such as:

    - ❖ The absorption capacity of the economy to efficiently invest revenue. If the money is floated into the economy, it results in the Dutch Disease which destroys the non-resource sectors of the economy, it will be inflationary and result in the appreciation of currency, which is catastrophic for the economy. It is therefore important to release what the economy is capable of absorbing.

    - ❖ Be able to identify opportunities to diversify from non-renewable sources of revenue, to invest in human capital and other capital infrastructure that will generate additional sustainable income;

    - ❖ The sensitivity of revenue to the expected volatility of commodity prices;

    - ❖ Concerns on Dutch disease; and

    - ❖ Demographic trends and inter-generational equity – maximize the sum of utilities of all the generations stretching to the infinite horizon. There is need to invest for the future, including infrastructure development as that will help the non-resource side of the economy and intergenerational equity, to preserve current income for future generations.

Mr. Murira pointed out that Kiribati is an example of how government has been able to build a pool of assets with long-term benefits for future generations. This is in contrast to the case of Nauru which had very similar starting conditions and policy choices to some extent but very different ways of nurturing and managing resources.

He emphasized that the ability to build inter-generational equity is a critical component of any country's key policy choices.

Spend/Savings Tradeoffs

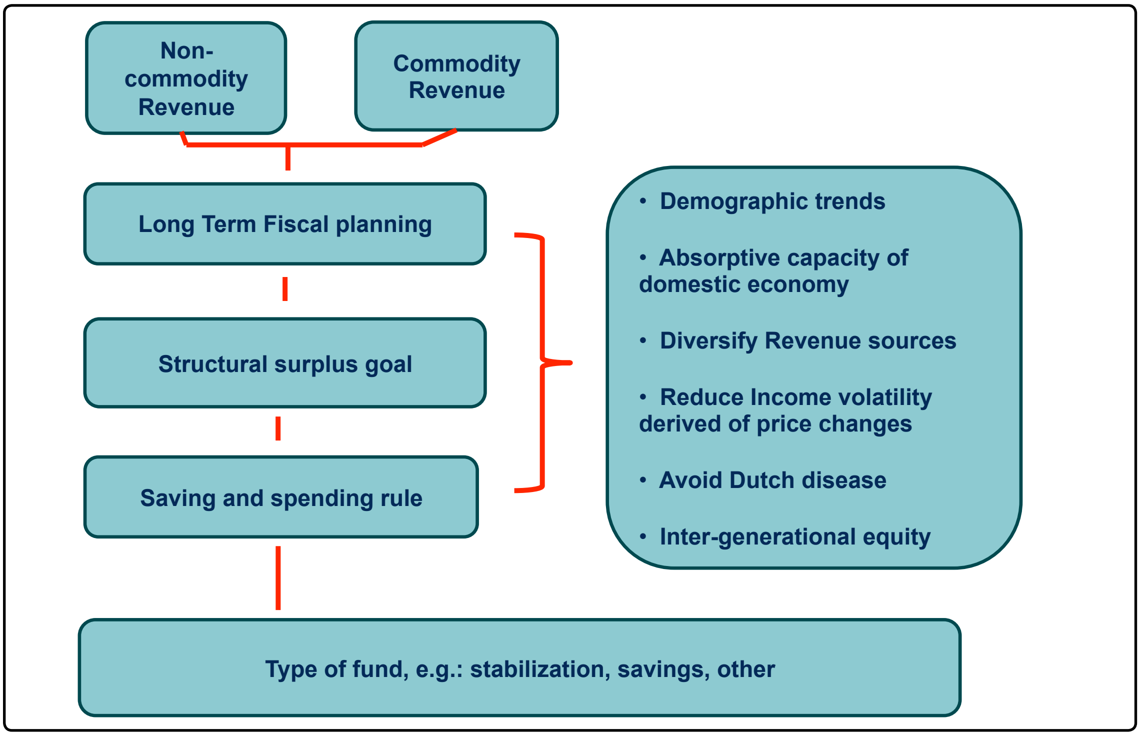
- The question of how to combine moderate increases in public spending with a medium/long-term strategy for national savings may complement fiscal policy as follows:
  - ◊ Reduce the impact of the resource revenue volatility on the budget;
  - ◊ Mitigate against the macroeconomic impact of large foreign exchange inflows;
  - ◊ Smoothen the spending over time – in line with the spending capacity of implementing agencies; and
  - ◊ Help promote inter-generational equity.
- Spending/saving of the resource revenue should be guided by the changing commodity prices and exogenous production variables.

It was underscored that there is need to have appropriate fiscal targets and to transform those targets into fiscal rules that spend some component that is sustainable and saves funds for hard times.

Design Components of the Long-Term Strategic Objectives

This is illustrated in Chart 4 below.

Chart 4: Design Components of the Long-Term Strategic Objectives

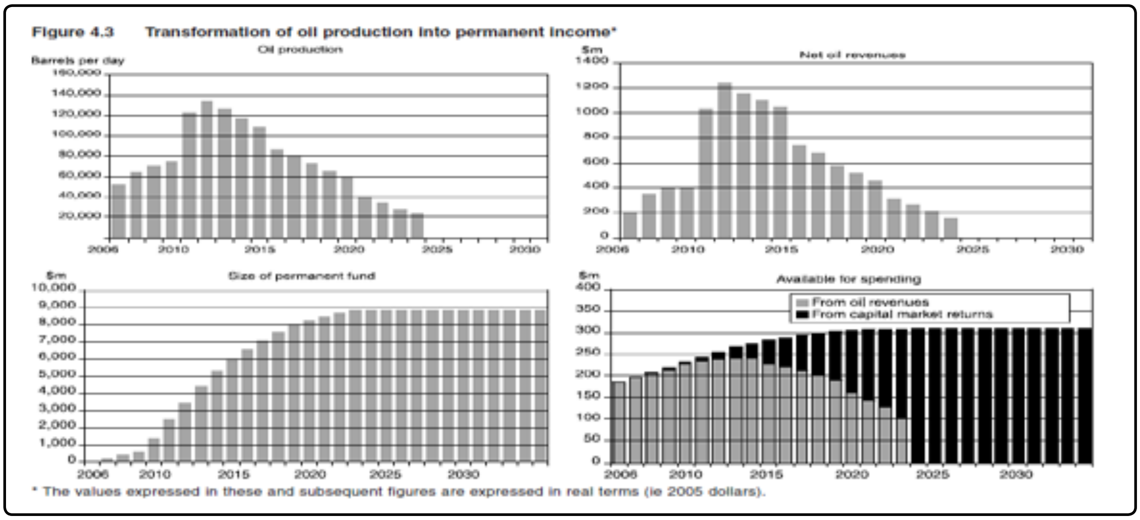


Source: World Bank

Transformation of Depleting Resources into Permanent Income

In order to address depletion of the finite commodities, achieve intergeneration equity transfer and insulate the domestic economy, the resource revenue may be accumulated and invested in foreign financial assets (and not in domestic assets).

Chart 5: Policy Choices on the Use of Revenue Will Determine the Type of Savings Fund



Source: J. Johnson-Calari, A. Berkelaar, "Commodity Funds for the Future", RBS Reserves Management Trends 2006

The critical design feature is the procedure to determine transfers and withdrawals to meet the long-term objectives, which formalizes the decision on how much to spend or save.

Table 1: Objectives and Type of Fund	
Objective	**Type of Fund**
Smoothing budgetary cycles.	Stabilization
Ensuring Intergenerational equity	Future
Preserving capital to generate alternative sources of revenue different from non-renewable resources	Endowment
Meet long term contingent liabilities	Special purpose Fund

It was pointed out that the savings and withdrawals rules should be based on the analysis of a sustainable long-term public spending path.

Table 2: Examples of SWFs

Objective	Examples of sovereign wealth fund
Macroeconomic stabilization	Abu Dhabi Investment Council Chile Economic and Social Stabilization Fund Kazakhstan National Fund Mongolia Fund (tentative) Russia National Welfare Fund
Future generation savings	Alaska Permanent Fund (U.S.) Alberta Heritage Savings Trust Fund (Canada) Australia Future Fund Azerbaijan State Oil Fund China National Social Security Fund New Zealand Superannuation Fund Norway Government Pension Fund–Global Permanent Wyoming Mineral Trust Fund (U.S.)
Management of government holdings	Mubadala Holdings (UAE) Tamasek Holdings (Singapore)
Wealth and return maximization	Abu Dhabi Investment Authority China Investment Corporation Government of Singapore Investment Corporation Korea Investment Corporation

Sources: Milken Institute, JPMorgan Research

The methods of transfer to citizens differ from country to country. For instance, Alaska presents cheques to citizens.

Domestic Vs Foreign Investing

It was noted that this was an important policy choice. The critical question has always been on the choice of whether to save or address the needs of citizens. It was pointed out that investing overseas allows diversifying the economy away from the domestic economy. However, there is a growing interest in investing domestically. Some of the arguments supporting this view include:

- Mobilizing domestic savings to finance long-term infrastructure projects which generate additional revenue for economies;
- Domestic investments could be used to promote economic diversification and offset Dutch-disease effects by boosting the competitiveness of key non-resource sectors

such as agriculture, industry and also to expand access to finance by Small and Medium Enterprises (SMEs); and

- Return on investment in the domestic market may be higher than investment in foreign assets, particularly if positive economic and social externalities such as the impact on job creation are considered. These are short-term in nature and are more difficult to quantify.

Challenges of Investing in Domestic Assets

Macroeconomic challenge of managing the Dutch disease. The risk that the resources may flow into the economy much faster than the economy can be able to sustain. The long-term effect might result in destroying the non-resource sector.

This may be due to lack of capacity;

- Vulnerability of the governance structure to political interference;
  - ◊ There is no precedent for a successful SWF with authority to invest domestically in a weak institutional environment; and

- Conflict between development and investment objectives.
  - ◊ Development vs. commercial investment requires different institutional arrangements, investment processes, governance structures, skills and other policies. There is need to leverage on the private sector which is more disciplined.

Summary of key issues

It was proposed that a possible alternative is the adoption of a three-tier structure:

- The SWF invests exclusively in foreign assets that are diversified away from the economy. This is why there is a strong case for foreign assets;

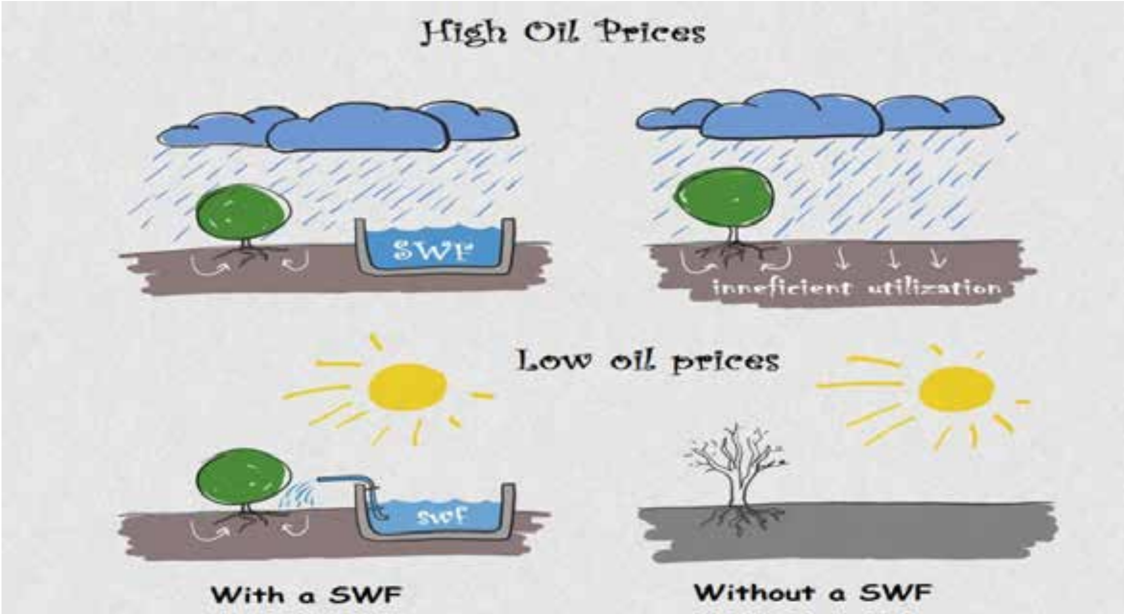
- A government-owned holding company for investment in infrastructure (funded through the budget); and

- A public venture capital fund to finance SME, agriculture and start-up companies (funded through the budget).

What Will Happen When the Good Times Come to an End?

Chart 6 illustrates the choices that economies are faced with and that without savings, during hard times the economy faces challenges. There is, therefore, the need to move from the natural resource space to a more sustainable space where during hard times, the economy can remain more diversified and sustainable.

Chart 6: Low and High Prices



Source: World Bank

C. INSTITUTIONAL ARRANGEMENTS FOR MANAGING LONG-TERM SAVINGS

Three main elements of a Savings Fund Policy were identified:

- Macroeconomic policy and investment strategy.
  - ◊ Optimal strategy contingent on macro role of fund.

- Investment strategy and governance.
  - ◊ The complexity and risk of the strategy will determine the need for robustness in governance.

- Governance and macro policy
  - ◊ The governance structure must give sufficient legitimacy to justify accumulation of assets.

It was noted that these choices inter-relate and impact one another and the optimal strategy depends on the macro role of the fund. For instance stabilisation funds are more short-term; Hence, the governance policies are quite different as well, depending on macro strategies and objectives.

Key Institutional Risks Facing Long Term Savings Funds
A key challenge that faces savings funds over time is the conflict between their strategic objectives and short term political objectives as can be reflected in the following risks:

- **Direct raiding:** funds are used for purposes other than originally intended or ex-ante contributions are not paid;

- **Indirect raiding:** unsustainable fiscal behavior e.g. excessive debt accumulation on the back of fund's resources or other forms of front loading. Spending in anticipation of future revenue can build up debt in a very unsustainable way; and

- **Inefficient management of the funds**: constraints on investments that is inconsistent with the fund's long-term objectives because of reputational risk concerns.

The Institutional Arrangements for Managing Long Term Public Funds

The institutional arrangements cover a wide spectrum of possibilities to balance two competing demands to obtain legitimacy:

- The need to ensure stakeholder representation to design appropriate investment policies at the highest level of decision-making in the government or ministry or trustee for the government; and

- The need to build a specialized financial management infrastructure to efficiently implement policy decisions. There is need to delegate to specialists and develop or create a specialized financial management infrastructure to manage and implement the policy choices.

The Santiago Principles Set Out Key Guiding Principles

- The soundness of the legal framework to enable the Fund to accomplish its stated objectives.

- The strategic objectives of the Fund should be clearly defined and publicly disclosed, in particular, the criteria that governs savings and withdrawals.

- Transparent disclosure of investment objectives, strategy and risks.

- The institutional arrangements for managing the funds should be shielded from political interference and facilitate the efficient management of the funds to achieve their objectives.

- Independent, knowledgeable and effective oversight mechanisms should be in place.

It was underscored that the Santiago Principles is a good body of literature that should be drawn upon to be able to design the governance principles. ***Some Fundamental Governance Principles include:***

- Clarity of institutional objectives formulated in the legal mandate.

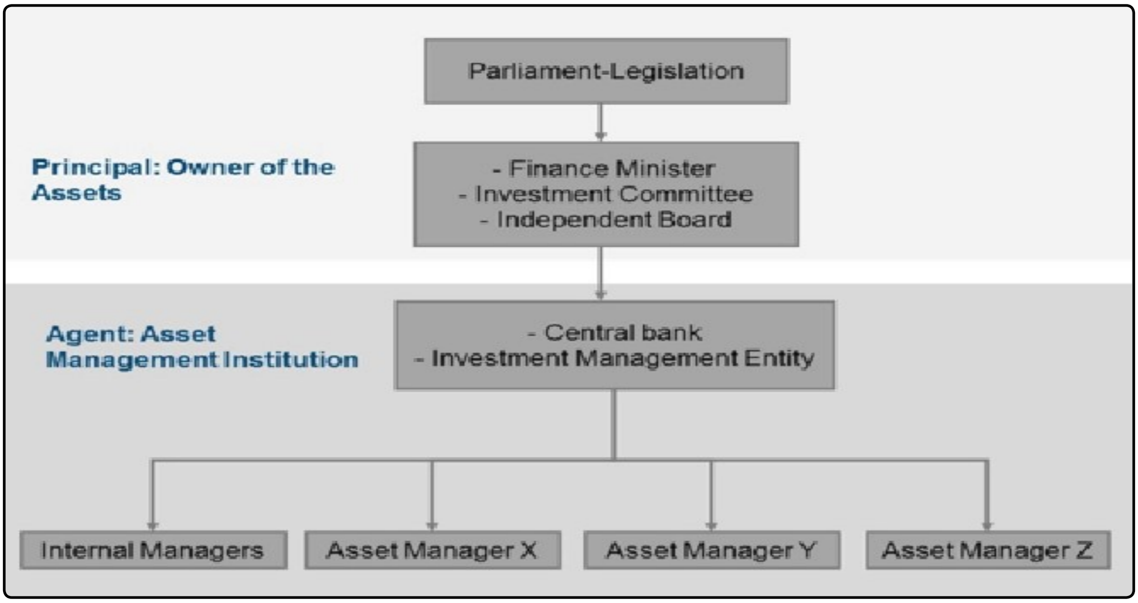
- Informed policy-making. This includes ownership of the risk/return profile of the portfolio at the highest level of sponsorship.

- Clear delegation of authority and accountability for implementation to a specialized asset management entity.

- Effective controls and oversight supported by well-recognized standards of prudential care.

- Transparency and communication.

Chart 7: A Generic SWF Governance Model



Source: World Bank

Governance Arrangements

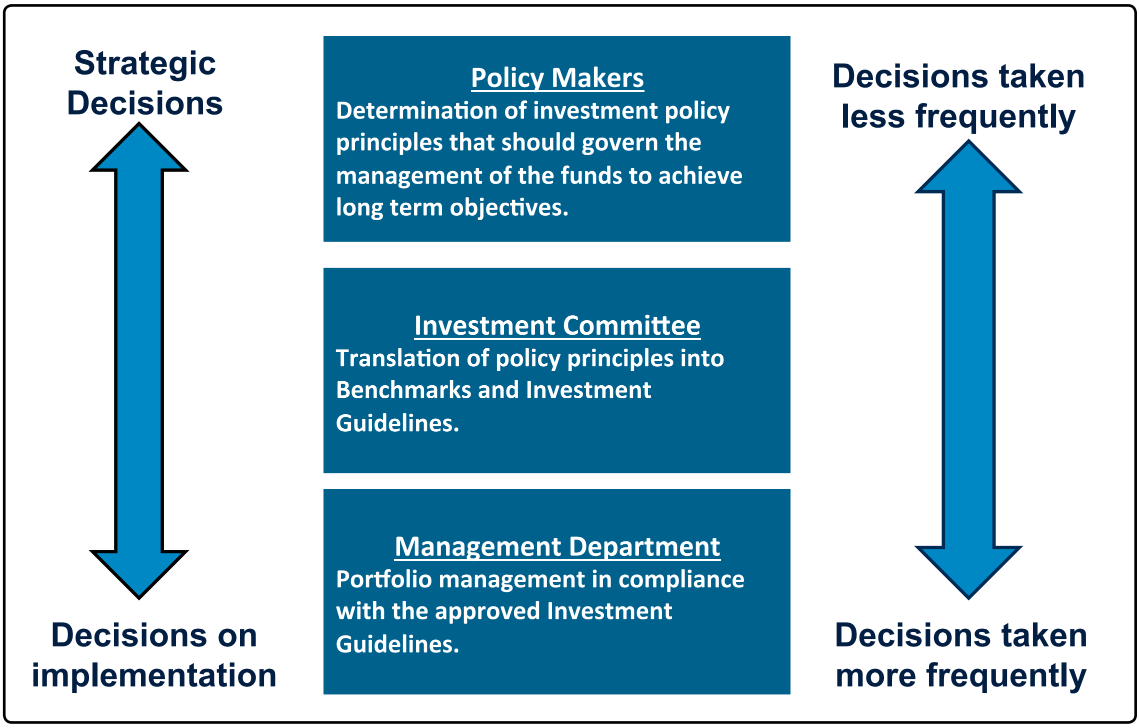
- As indicated in chart 7, the governance arrangements to manage long term funds cover a wide spectrum of possibilities, with varying degrees of independence from government, in order to balance two competing demands:

  ◊ Informed policy making and ownership of the risk/return profile of the portfolio to meet its strategic objectives at the highest level of sponsorship; and

  ◊ Delegation of authority and accountability for implementation to a specialized financial management entity.

- The lack of an appropriate framework to segregate policy decisions from implementation can lead to imposing inefficient constraints on investments that are inconsistent with the investment horizon and risk tolerance.

Chart 8: Governance: Who Makes Which Decision?



Source: World Bank

Chart 8 above indicates that decisions are delegated downwards with information flowing upwards. This ensures transparency and strength of institutions.

Examples of Governance Arrangements for the Management of SWFs

- Strategic asset allocation ownership at the highest level;
  - ◊ Ministry of Finance: Norway, Chile, Russia;
  - ◊ Investment Committee of financial experts and political representatives: Alberta, Trinidad & Tobago; and
  - ◊ Independent Board appointed by Ministry of Finance following the recommendations of a nominating committee: New Zealand.

- Delegation over implementation to a specialized entity:
  - ◊ In the Central Bank in a specialized asset management division e.g. Norway, Trinidad, Chile, Russia; and
  - ◊ Separate Agency managed at arms-length from government: New Zealand, Libya and Singapore.

- Independent oversight mechanisms.
  - ◊ Government Auditors, supervisory authorities and external auditing firms.

Key Messages

- The macro-economic challenges and impact of natural resources booms for developing nations poses well documented challenges:
    - ◊ Need for fiscal stabilization to avoid boom and bust cycles;
    - ◊ Need to generate alternative sources of income different from non-renewable resources; and
    - ◊ Need to save for future generations.

- A key policy choice is to design an appropriate fiscal framework, comprising appropriate fiscal targets and rules that guide public spending/saving, to ensure fiscal sustainability.

- While investing domestically may foster economic growth, both macroeconomic constraints can place a cap on the level of domestic investments.

- The Santiago Principles set out good practices for overall governance and inform the key policy considerations in the management of natural resources.

- There is no single right model for the institutional set-ups to manage a country's SWF. The country specific context matters. Guiding principles may include:
    - ◊ Institutional mandate and the fund(s) objectives
    - ◊ Institutional autonomy and independence from political interference
    - ◊ Legitimacy and operational capacity
    - ◊ Legal and sovereign immunity issues
    - ◊ Ability to attract and retain qualified staff

- The institutional arrangements to manage long-term savings funds cover a wide spectrum of possibilities to balance competing demands:
    - ◊ The need to ensure stakeholder representation to design appropriate investment policies at the highest level of decision-making; and
    - ◊ The delegation of authority and accountability for implementation, including the need to build a specialized financial management infrastructure to efficiently implement policy decisions.

Discussions

Honourable Gatete highlighted that SWFs are not only meant for those with natural resources. He stated that those with limited natural resources like Rwanda have established a dignity fund contributed by citizens willingly and the Government through the budget. He indicated that the government has also taken a decision that for every natural resource that is found, a certain percentage is apportioned to the fund for future generations.

Mr. Reitveld sought clarification on the model used by the World Bank in making decisions on how to allocate resources to the three priorities. He also sought clarifications on how important it was to have an accurate and reliable forecast for each priority with regard to prices and their interaction with investment.

Governor Shiimi from Bank of Namibia noted that the presentation was in sync with the sentiments of the World Bank Treasurer that, *"society grows when leaders plant trees whose shades they will never sit under. "* He sought guidance on the best investment choices i.e. to invest in education or establish a SWF or invest in infrastructure or put some money away. He also wanted to know at what point countries should start building these funds. Should it be when there are huge surpluses which cannot be absorbed by the economy or countries have to start investing or putting some money away even when there are needs for infrastructure and investment in education.

Mr. Keith Muhakanizi, Secretary to Treasury, Uganda, noted that for most countries, the current situation was not in the boom as the economies have been shocked and they are down. Countries invested over the last decade but now prospects are down and the question is how countries can manage the transition back to the growth path. He noted that the challenge for most MEFMI member countries was how to manage the short-run. In a number of African countries, much of the budget is now in investment. But the challenge was that countries have borrowed to put up infrastructure that is now half complete. In the case of Uganda, a kind of Dutch disease has been experienced through high expectation on oil revenue which needs to be managed as some countries are starting from the burst and not from the boom.

Mr. Christopher Mvunga, Deputy Minister of Finance and National Planning, Zambia observed that the issue was on how countries should move away from normal budget to structured budgeting. He stated that in most of these things, it was not the content or the technique but it was about how to change the mind-set in terms of legislators, the general public and on governance. He underscored that without mind-set shift, some strategic changes might have to be forgone even though they are beneficial and desperately need to be addressed, in order to ensure future benefits. He emphasised the need for public sensitisation and creating a strong planning unit in countries with governance structure which talks to the people running the communities. There is need to sensitise the private sector as well and strike a balance between real economists and political economists because they are interdependent. Unless sensitisation is done to get stakeholders buy-in, it will be very difficult for a Minister of Finance and National Development to explain why there are no books in schools because there is a SWFs.

Governor Mangudya from the Reserve Bank of Zimbabwe noted that there is a clear relationship between those that have managed their SWFs well and the resultant development. That is, there is clear relationship between safety of money in SWFs and development. His question was however on where best to keep the funds in terms of safety, given that there are security disturbance throughout the world. Is it in Africa or outside? He pointed out that if the US$ 7.1 trillion can come to the continent it can bring development.

Mr. Murira underscored the need for integrated policy choices. The options of where to spend, save, and how to save exist but they need to be consistent to country's development plans that are all encompassing. The challenge will be on the implementation timing as this is dependent on two critical issues of national vision and courage by the leadership. It was noted that invariably countries are always faced with many competing needs. He cited the case of Rwanda where the country has limited natural resources but they have a dignity fund which will benefit future generations. He underscored that for countries that are yet to implement a fund, there was no better time than now. He emphasised that a balance can be created between competing needs and the need to save by having a small amount dedicated to savings while the rest of the revenue will be channelled towards addressing other major needs of the country.

He underscored that Governments must have the capacity to identify appropriate future growth areas. Funds from natural resources and revenue from the fiscal space or some savings - as is the case of Rwanda - should be able to support a country's development plan. The strategy should be to have balance between competing needs such as infrastructure and others.

Regarding price forecasting, Mr Murira stated that it was clear that this is not possible as there are many variables to be considered. Historical information can be used as a guide for decision making purposes. He urged countries to make clear decisions on how much of the revenue earned from those assets can go into the fiscal budget (which includes some kind of estimation of future expected revenue), which is again an area of significant uncertainty.

Honourable Gatete concluded by noting that it was crucial that countries create funds from revenue realised from natural resources. Policy makers should also be cognisant of other competing national needs that have to be taken into account when making investment decisions.

2.4 SESSION 3: TAXATION OF NATURAL RESOURCES: PRINCIPLES AND POLICY ISSUES

Introduction

This presentation was chaired by Honourable Christopher Mvunga, Deputy Minister Ministry of Finance and Economic Development, Zambia and presented by Charles Makola[3], Director, International Tax Services and Partner, EY.

Honourable Mvunga opened the discussion by citing the popular saying "***Expenditure always rises with income but income does not rise with expenditure".*** He stated that one of the key areas and challenges in Africa and across the world where ICT systems are

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[3]Mr. Charles Makola is Partner-International Tax & Tax Policy, Africa, EY. Charles joined EY in November 2013 from National Treasury South Africa. Charles provides international tax and exchange control solutions for inbound and outbound investment. He is a lawyer with 10 years of tax experience; four years of which were spent writing tax legislation as a Director at the South African National Treasury. He has lectured at several South African Universities since 2001 and to-date, maintains a close relationship with the University of Pretoria as a visiting lecturer of Tax. He graduated with LLB, LLM (UP), and H Dip (Tax) (UJ). In addition to international tax advisory, Charles links with all our Africa Tax Partners in 33 countries to actively influence and participate in tax policy development in Africa.

still being developed, is the predominant usage of cash systems and taxation therefore becomes a very interesting topic, in terms of how countries maximise revenue collection.

Mr. Makola noted that both corporates and individuals have investment decisions that they should make in relation to salaries and income. The choices that are often faced are whether to spend money or to invest it on the stock market. He noted that while individual decisions seem simpler to make compared to corporate decisions, the choices are not easy in either case. As part of the team that was involved in negotiating treaties and transforming the South African income tax system he stated that he had an opportunity to visit some MEFMI member countries such as Kenya, Uganda and Zimbabwe. In the process, National Treasury of South Africa modernised the income double taxation agreement framework in relation to intra-Africa trade. The National Treasury of South Africa also moved with speed and managed to transform the South African income tax and fiscal framework to what it is today.

He stated that the BEPS project document expected to be released by EU is about six years late. The discussion paper becomes irrelevant to the South African case because the issues of discussion were covered six to seven years ago. He underscored speed in decision making as a key factor when making fiscal policy decisions, as that enables countries to progress and move forward in the development of fiscal and tax framework development. He noted that there is no perfect science instrument or factors that countries need to take into account. There are certain paradigms in which a fiscal framework needs to be set out and once this is done, speed in implementation is critical.

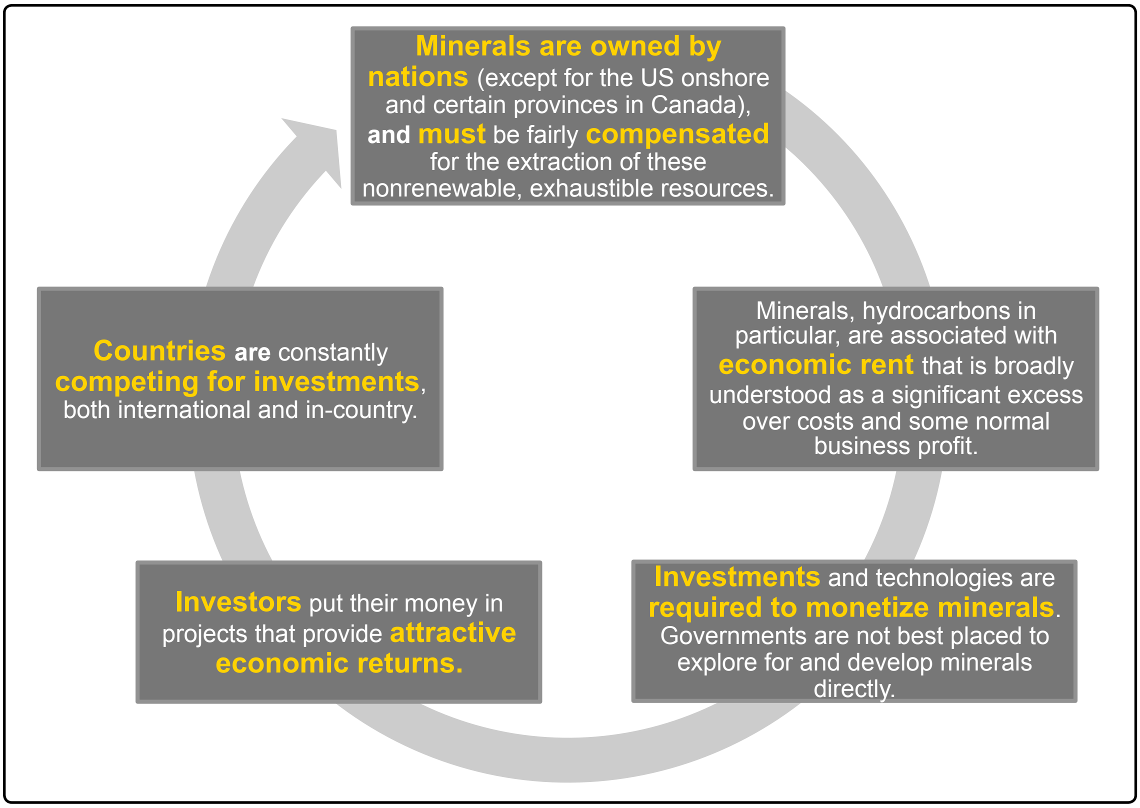
Taxation of Natural Resources

He noted that when designing a fiscal framework for natural resources, countries usually encounter difficult macro-social and political challenges. This is compounded by the varied interests of the various stakeholders. He gave the example of South Africa where the younger generation has resource nationalisation as a priority. He stated that there are socio-economic reasons that get the youths to make such issues a priority as they only get to hear of the financial gains that are made by the mining sector in particular. This includes the monetary gains that they see being accruing into the fiscus, an example being the US$3 billion which the mining sector in South Africa has been making contribution into the fiscus. They are also aware of the large financial gains that accrue to companies and individuals who invest in a low tax jurisdictions.

It is such disparities that are fuelling the debate on the design of fiscal instruments that are resilient, competitive and equal to cope with and capture the relevant economic structure that a country seeks to recoup in the area of natural resources.

He pointed out that some of the difficult choices that countries face are captured in the four quadrants in Chart 9 below:

Chart 9: Simplified economic and political framework for minerals



Source: EY

He emphasised the need for countries to have instruments that are revenue buoyant - fiscal instruments that are able to respond during the good times and to positively respond in respect to a country's central revenue fund during bad times. Countries want a certain level of guarantee of revenue stream to be generated by the fiscal instruments. Countries also want instruments that capture the stock of incentives and stock of fiscal stabilisation. He noted that in most cases the design of fiscal framework for natural resources needs to also take into account the backward and forward economic linkages to be encompassed in their design.

The amount of revenue that countries hope to raise from the mining sector needs to take into account the indirect contribution by the mining sector to the economy. This makes the policy around natural resources extremely difficult. The situation is compounded by a decrease in employment in this sector as well as reduced contributions to corporate income taxes and declining contributions to the real GDP by the mining sector.

All these challenges call for an instrument that can effectively respond to these issues. A fiscal instrument that can raise revenue without jeopardising the exploration budget. The instrument should be easy to administer and with certain elements of resilience.

The other challenges that are peculiar to Africa are that countries do not cooperate amongst themselves despite having similar nature of mineral resources as well as generating the same products. There need is need for the region to cooperate in order to influence world market prices. In this regard, countries are more of price takers instead of being price makers. This is a big challenge that has resulted in the rent capture with respect to natural resources being compromised in many respects.

One spectrum of the challenge are the domestic and global market fundamentals that countries face. From the investors' perspective, there are about five core arguments that countries need to take into account.

- The long exploration period that is required in the mining industry. A large budget is required at the initial stage of the business. Success in this type of business requires appropriate responses by countries as it ultimately impacts on the required rate of return in respect of every investment project.

- Long production periods to reach break-even point are influenced by factors that sometimes are outside the business framework. This is mainly as a result of market fundamentals that affect commodity prices.

- Beneficiation or value addition.

- National development responsibilities such as roads for countries with infrustructure deficits.

- Countries also need to be realistic with respect to the fact that most mines that have been rehabilitated remain ghost towns and it is very hard to revive economic activity in the form of high yielding mineral towns.

Tax Instruments

The questions here include: what are the instruments and the required fiscal regimes that countries can consider?

There is a combination of instruments and there are various or several broad categories that countries can consider as follows:

i Rent Based Taxes.

During the boom period, countries are able to realise an appreciation in the revenue generated by the investor community. These come with tax variations such as the brown taxes which is basically a constant rate that is applied in certain instances on gross sales, etc. There are a lot of nuances in designing the required resource rent tax appropriate for a country.

Mr. Makola pointed out that in the South African context, the ruling party has come up with a debate on the Australian Model of mineral resource taxation; This is despite the fact that the country has a royalty taxation that already captures that which was also tested on how it responses to the various variables relating to the market performance.

This shows that political debate in certain instances is not quite realistic when it comes to the design of fiscal instruments.

Politicians have on the one hand, called for Australian model on mineral resources and on the other hand, royalty dispensation that actually provides more than what the mineral resources taxation does. He pointed out that investigations have shown that the royalty dispensation is much more resilient for South Africa and does better than the Australian model is able to achieve. It also captures the required rent with a variety of changes that could be done in the model without necessarily having to completely overhaul the entire system. The dispensation is backed by other models and other fiscal instruments on the side-lines.

He therefore underscored that the design of the rent-based model is very critical.

ii Profit Based Taxes and Royalties.

These are either based on accounting profits or taxable income determined by normal income tax framework in respective countries. The difficulty with this system, despite offering well known certainty and resilience with a couple of fundamentals, is the big transfer pricing. Because of capacity constraints in African countries, it is not possible to effectively police the transfer pricing models that are at play. Transfer pricing therefore becomes a critical issue to make sure that the profit element that is recognised for the purpose of taxation makes sense and is in line with international benchmarks.

Within the transfer pricing dispensation, countries are faced with other challenges. There is lack of intra-Africa trade and transfer pricing in general is based on comparables. Countries are facing lack of comparable because they don't trade with each other and the trade dispensations or trends are quite unique. Countries find themselves in situations where they have to compare the trade profile of certain activities undertaken in a market which is extremely different to its current market and current circumstances and having to compare it with home country industry. Thus the likelihood of coming up with distorted prices for purposes of transfer pricing is high.

iii Output Based Systems.

This system can perform in certain instances but is generally favoured for the sake of simplicity. Output based or value based system has the greatest advantage due to its simplicity in terms of enforcement from a revenue perspective and compliance by the tax payer community. However, it is resilient enough and guarantees the performance and resilience required during the bad and the good days.

Countries can design own fiscal dispensations to suit their particular needs. More often than not, there is no purist model for each of the three paradigms in terms of the broad frameworks of taxation that exist. There are combinations of the profit base.

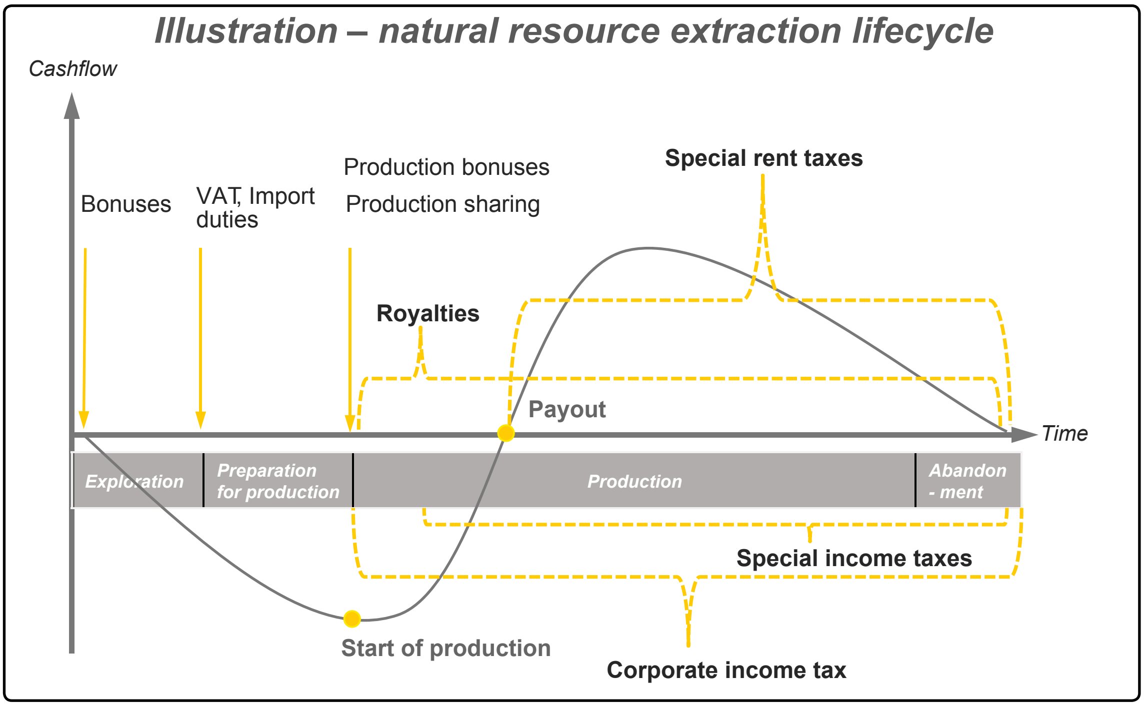
As provided in Chart 10 below, at the start of a business or at the exploration stage, countries are likely to find bonus payments or license payments. These are payments for having laid out the foundation or having been allocated the required licenses. This model is not recommended for fiscal instruments as there are difficulties that are likely to be experienced with bonuses because of corruption that influences payments.

During the exploration phase, when an investor puts a price on the required rate of return, there are certain sunk costs that need to be taken into account. Certain equipment, machinery and expertise will be imported subject to import duties and value added tax. The input taxes that are paid at this level (unless they are recouped at the post production level) become sunk costs. This is a big problem because it distorts the performance of the relevant asset and planning around this becomes peculiar, particularly in countries where investors are not recouping the required input VAT for the post production period.

Once it is determined that the mineral deposit are viable and production starts, that is when the various instruments come at play. The royalties will start picking up from production up to rehabilitation or abandonment of the mine. The royalty taxes, income taxes - if it is profit based and other taxes - will pick up depending on the performance of the asset.

There are other costs such as regulatory compliance which are all classified as taxes including the corporate income taxes because of the challenges when requiring revenue from this source.

Chart 10: The timing of government to impose taxes is crucial for profitable extraction of minerals



Source: EY

Core Variables of Performance

It was noted that when designing a model or a fiscal instrument, there are certain basics that countries need to comply with. It is required that the fiscal instruments be reviewed for performance against these three (3) core variables.

i Economic efficiency of the instrument

How neutral is the instrument, does it take into account the country risk or the sovereign risk of a particular country? What is the rent collection ability of the fiscal instrument? Is it flexible enough in terms of ability to collect the required returns during the good and the bad times?

ii Revenue delay

Does it provide or contain an element of revenue delay-post commencement of production? More often than not from production, countries may have to wait for a number of years before they start receiving income into the central revenue fund. The revenue delays need an instrument that could be used to perform against them.

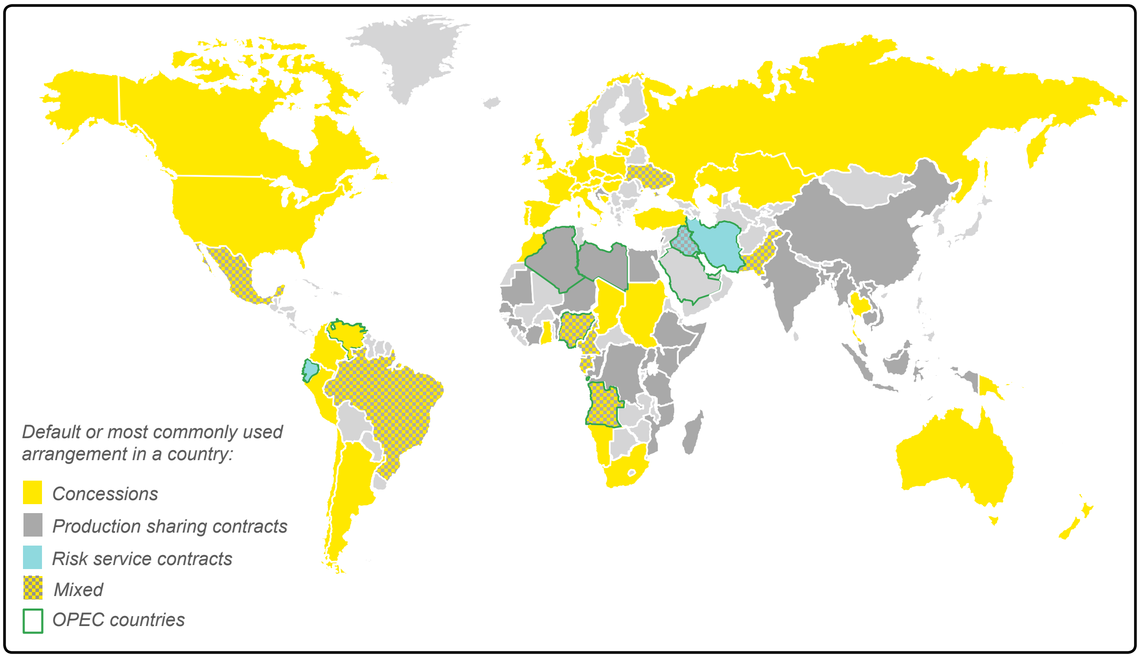
iii Administrative and compliance cost both from an enforcement and from compliance calculation basis

These are the fundamentals which if the fiscal instrument responses to each of these three (3) basics, then a country should be well on course to having a competitive fiscal arrangement and fiscal regime.

There is no one size fits all. Countries adopt various models. While some look at concessions, others focus on production sharing arrangements, service contracts and OPEC countries respond differently as shown in Chart 11 below.

But for most of the instruments, the issue is whether they can be tested against the three (3) core economic variables that have been indicated as basics. To the extent that it provides certain resilience and countries can maintain a certain balance in terms of revenue raising, investment attraction, compliance and administration, then a country will be well on course to having a competitive fiscal arrangement.

Chart 11: Legal arrangements for minerals (hydrocarbons): global snapshot



Source: EY

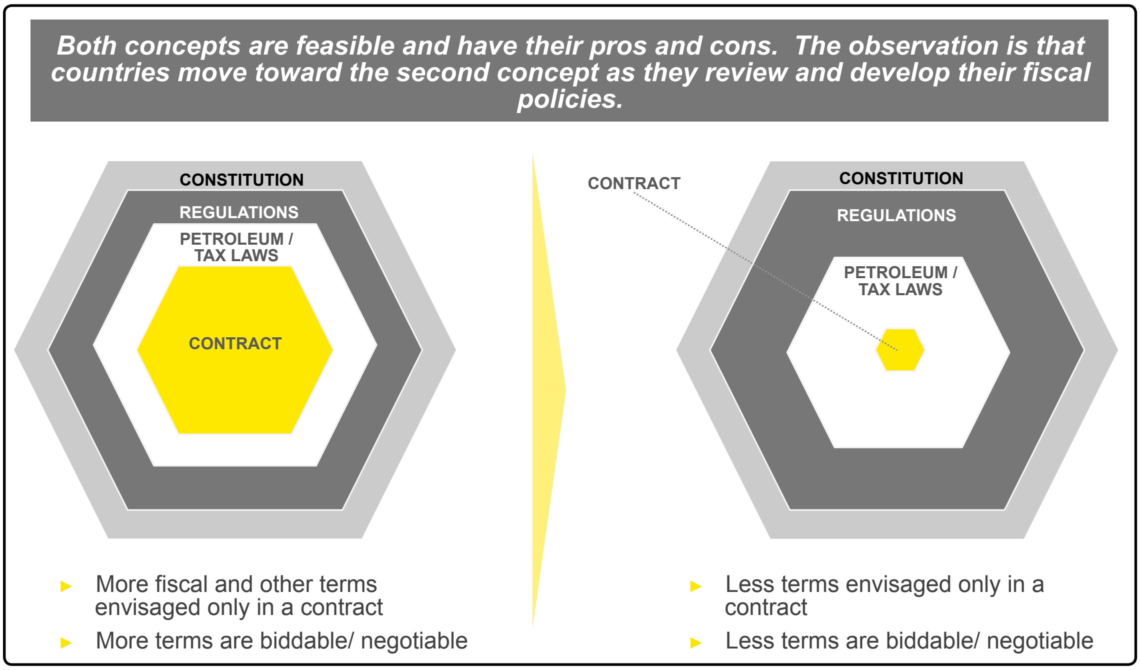
The performance of the various instruments against the three core variables rank differently for instance, profit based taxation takes into account the input cost hence has limited sunk cost, and the arrangement is more favourable for economic efficiency purposes.

On the other hand, output based taxes fiscal instruments are often favourable for simplicity in terms of enforcement and compliance from investors.

In this regard, certain element of balancing needs to be done in order to weight out a combination of the fiscal instrument to be preferred over the others.

Specific Contracts
In most cases, it is not possible to enter into a specific contract in relation to every single mining project. It can be done for the oil and gas sector, for specific mineral deposit projects or in relation to a certain number of investment categorised based on a country's economic needs.

Chart 12: Shift of countries towards contracts with lesser number of terms



Source: EY

The advantages of these agreements is that they are tailor-made for country specific purposes. What goes into the agreement provides fiscal stability and incentives on a project basis. Projects that do not fall within the agreement will then naturally fall into the normal fiscal dispensation such as the normal corporate tax and the normal royalties. These provide assurance to the investors in terms of the certainty of the project, for a period of about ten (10) to 20 years. Also of critical importance is provision of protection against political dispensations of the day. With enabling legislation, the core trends can be regulated by the core legislations and the various specific measures, including the rent capture that is regulated through the articles.

Transfer Pricing

Transfer pricing is critical across the continent. Legal instruments in this area have been developing tremendously and it is important that countries in the MEFMI region become abreast with global standards around transfer pricing. This is both in terms of capacity building and legislating of some of the proposed global framework and enforcement of the relevant provisions. This is quite critical particular for developing countries even though it comes from the Organisation for Economic Co-operation and Development (OECD) and the United Nations. The importance to developing countries is threefold:

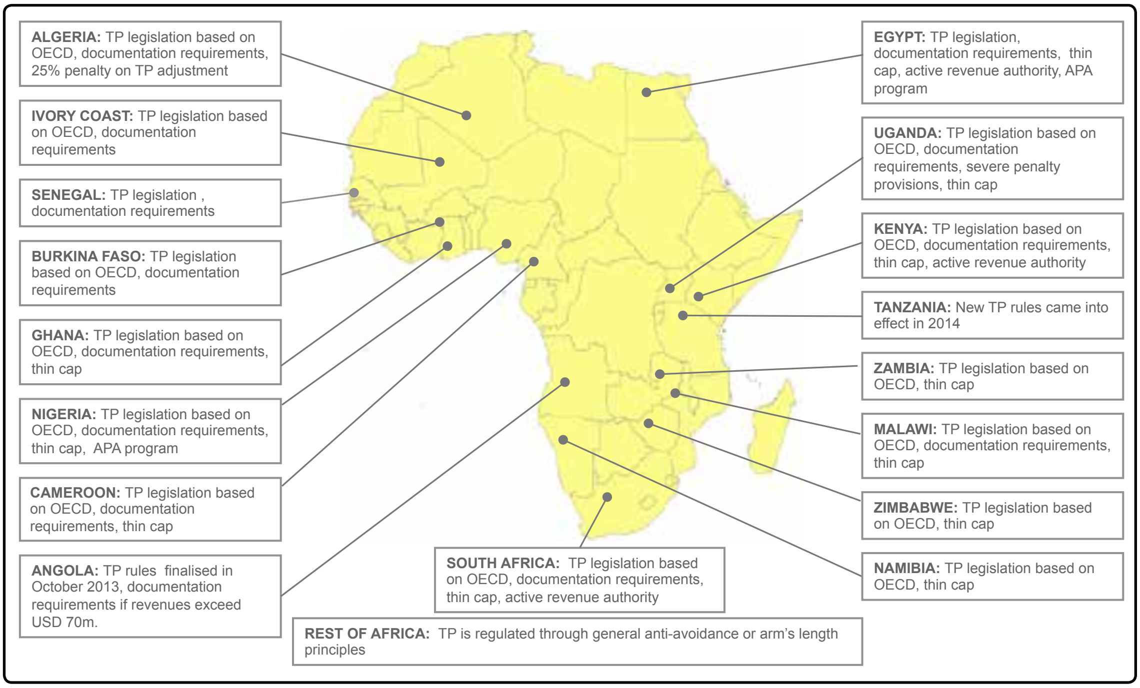
- **Access to information.** For the first time multinationals will be presenting to countries a multi-tier information base. Countries will have a master file that provides information to the fiscal or revenue department - what the investor's operating model looks like and the value triggers within the business at the global level. This gives a synopsis and effectively where the investor is making money - The transactions that they are entering into with related counter parties. This information will be at country disposal.

- More than 50% of actual global trade is taking place between related entities. This is at the core of BEPS. The whole notion that countries can recognise an insignificant amount of revenue in one country while recognising a substantial amount of profit in a low tax jurisdiction is precisely because of transfer pricing. In this regard, countries will have the information and will need to build capacity to be able to dissect the information. Capacity is needed to be able to enforce certain measures that may not be arms-length or might be considered to be eroding the relevant tax base.

- Developments in this area cannot be seen or cannot be divorced from the design and development of the natural resource policies. Across the continent, this has been a significantly debated issue and several countries have started projects in terms of documenting by either putting together enabling legislation or regulation on documentation requirements as shown in Chart 13.

  This is an area that should be taken very seriously and the training and capacity should be built with speed to be able to make our fiscal instrument much more relevant and resilient within the natural resources sector.

Chart 13: Transfer pricing Africa footprint overview



Source: EY

Impact of the Global Oil Prices

With regards to the impact of global oil prices on the performance of certain fiscal instruments, there is no one size fits all. Countries responded differently and this is measured against the various price scenarios per barrel (see Chart 14 below).

Chart 14: Impact of current low oil price environment: Our methodology and approach

To analyse the impact of the oil price drop we have selected 115 regimes in 50 countries for five types of oil projects:

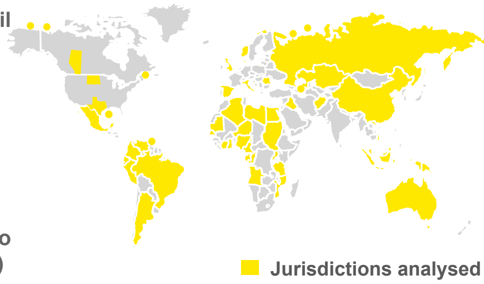
- Onshore
- Onshore unconventional
- Shallow water
- Deep water
- Arctic

Our analysis has used the economic model of Dr. Pedro Van Meurs (under our global cooperation arrangement)

Cost data for each country and each type of oil project was based on Wood Mackenzie's Upstream Data Tool

The fiscal regimes were analysed under six oil price cases:

- US$100/bbl (benchmark case)
- US$60/bbl
- US$55/bbl
- US$50/bbl
- US$45/bbl
- US$40/bbl



115 **Regimes analysed in**

50 **countries**

Source: EY

- There is no clear cut or constant response. The US started revising their royalty mix.
- Mexico examined their internal rate of return.
- Africa's response will depend pretty much on the various economic needs of the relevant countries.

Key Messages

- Countries must do small things and implement.
- Countries need to build capacity in revenue authorities and national treasuries on policy design and enforcement by revenue authorities.
- Review fiscal instruments for performance against certain core variables and measure their resilience and how much revenue will be generated from each of them. To the extent that certain studies are required, countries need to be able to make these decisions.

- Countries need to speak to the investor community on some of the concerns as designing a very resilient tax system will need extensive consultation with the investor community. Countries need extensive study visits in peer countries as part of the process of designing models that work for the relevant country. Not all models that have been adopted elsewhere will naturally work in all countries because of the various unique influences on the taxation of natural resources.

- Countries need to stay competitive. Countries need fiscal instruments that are comparable.

- Countries need to be transparent in the design and development of fiscal regime policies. Where incentives are granted, countries need to measure how the incentive is spent. Countries need to measure the efficiency. Most countries have incentives but they do not know the impact on the economy. What is the cost of the incentives to countries? What does it give to investors? There are incentives that have been in place for over 15 years without significant uptake from the mining sector and venture capital investors. It is therefore very critical that countries offer fiscal instruments that are relevant and speak to the needs and demands both of the investor and the domestic requirements as a country based on country specific needs.

Discussions
Honourable Mvunga expressed the need for countries to seriously consider the issues of transparency raised in the presentation and need to be wary on the socio-economic factors, as countries set their tax instruments.

Mr. Mutimba, MEFMI Director Financial Sector Management (FSM) Programme, alluded to MEFMI led visit to Norway were the team observed that there is strong revenue audit function to oversee the oil revenue for private sector companies that have concessions for oil production, with a focus on transfer pricing. In particular, Mr. Mutimba sought clarification on the status of transfer pricing on the Africa continent.

Honourable Ms Ericah B. Shafudah, Permanent Secretary, Ministry of Finance, Namibia sought clarification on how some countries have overcome the challenges of double taxation agreements. This was in view of the fact that some of the countries in the region cannot accrue more revenue taxes from natural resources because they have been locked in agreements since independence as is the case for Namibia which is not maximising revenue from natural resources.

Honourable Chinamasa, Minister of Finance and Economic Development, Zimbabwe also sought for clarification on the extent to which African countries have the capacity to oversee transfer pricing and the key elements that countries need to put in place to come up with a model that prevents the problem in Africa (executed through inflated investments with a bearing on the dividends that are repatriated outside the country).

Honourable Gatete noted that there were similarities in the natural resources that countries are talking about. The problem is that there are contracts in each country with global companies and in most cases they are in favour of the contracting company.

He sought further clarification on whether there is a common template or model to use for contracts, incentives and taxation that countries can share since these are done differently due to lack of capacity.

- ***Double Taxation***

Mr. Makola stated that when he joined the National Treasury of South Africa, his mandate was two-fold: To design the domestic and international tax framework and secondly, the renegotiation of double taxation agreements or the set-up of the double taxation agreement for South Africa which was locked into zero rate treaties with low tax jurisdictions in the Netherlands and Luxemburg, Singapore, Switzerland and Mauritius. The work started with Mauritius where benchmarking was done.

He pointed out that countries need to be extremely cautious with double taxation agreements they get locked in for many years while on average, it takes about three years to amend a double taxation agreement. He noted that there are instruments not so much intended to facilitate investment but intended to provide certainty by means of fiscal stability. For instance, with a domestic rate of 15% in a double taxation agreement, this can be stabilised into 5% or 7% based on domestic tax policy requirements.

He underscored that it is very critical that a currently negotiated treaty looks forward to support development and the financial requirements of the country. In the case of South Africa, there were many treaties in the 1990s immediately after independence due to excitement which saw signing of many treaties that came on providing zero rates. At a later stage, these meant that there were distorted capital structures for multinationals. The question was why should investors invest on equities if they can invest on debt and get the interest on the coupon on that investment at a zero rate.

In this regard, he noted that countries need to negotiate double taxation agreements based on a forward looking approach to the development of the domestic tax policies. Countries need to manage exemptions and incentives for investment through the domestic instruments and not through bilateral instruments.

It was underscored that treaties are not the appropriate instruments to be granting incentives. If countries want to tax dividends at zero rates, it must be put in the domestic legislation and locked in a rate in the double taxation agreement.

- ***Service Charges***

Mr Makola noted that the greatest issue faced across the continent where there are several multilaterals is on service charges. He pointed out that naturally operating models are more centralised in terms of shared services tax that are rendered across the group, with some sitting in other jurisdictions rendering services that need to be charged ultimately to avoid paying taxes on revenue not received in respective countries.

For instance, if the shared services are sitting in one country rendering services to entities in other countries, charging 100 and the cost base is 90 meaning that the margin is 10 and there is a withholding tax on gross basis at 10%, which starts to eat up on the cost base of those services. This impacts significantly on the operating model that multinationals get structured and push for decentralisation of shared services to obtain economies of scale in the particular country or employing someone to render the service in the country. There is a challenge as most technical assistance does not allow most countries to tax services.

He noted that a great error that has been made during the negotiation phase is not making provision for technical services to be taxable in the double taxation agreements. Countries are therefore locked in an instrument that will take many years to amend.

He pointed out that most African countries are doing relatively well in negotiating various double taxation agreements except for the technical fees on the services.

- ***Capacity on Transfer Pricing***

With regards to transfer pricing, he underscored that there is no capacity to police transfer pricing across the continent. While Kenya and South Africa have made some significant inroads, there is no available skills base to expand further. Therefore, the region needs to build capacity in this area. The existing capacity is sitting in consulting firms, doing benchmarking; looking at comparable prices, profit sharing etc. and countries need to build the relevant capacity to address domestic needs.

It was noted that importing capacity is good but tricky in the sense that what is seen in one market is not necessarily what is happening in the domestic market. Transfer pricing is not a precise science, it is extremely difficult to import capacity rather than growing it from within. He recommended growing capacity within and referred to the various initiatives driven both by EY and the OECD initiatives such as tax inspectors without borders. The key however is mainly on how to grow within countries. By doing this, there will be changes in the levels of revenue flows to the fiscus.

Countries were cautioned to note that every single payment that gets out of a country is not necessarily base erosion. Shared services are not profit centres but are cost centres and must charge for services. A rate of 4 to 9% was recommended. Gross taxes on shared services are therefore actually taxes on the base. In certain countries, in addition to withholding taxes, there is a reverse charge in VAT as is the case in Zambia.

- ***Contracts***

Mr. Makola shared a basic framework of the items which could be considered in contracts. He pointed out that generally, contracts are tailor-made and depend on various items including the sovereign risks of the country which may influence some of the terms of the contract. He further stated that contracts are purely instruments of negotiation based on the enabling legislation. In this regard, looking at the enabling legislation, it may be possible to provide a framework on some of the core items that will generally be considered given the enabling framework.

2.5 SESSION 4: SOVEREIGN WEALTH FUND MANAGEMENT: THE CASE OF BOTSWANA

The session was moderated by Prof. Benno Ndulu, Governor, Bank of Tanzania. Professor Ndulu noted that Governor Linah Mohohlo[4] who presented during the session was managing a SWF for a country that is a success story for the region. The case of Botswana has proven that Dutch Disease is avoidable. He pointed out that delegates have an opportunity to learn how to manage SWFs properly in view of her wealth of experience

Governor Mohohlo explained Botswana's economic and external position; management of reserves in partitions and the establishment of a long-term fund for future generations, popularly known as the Pula Fund. She stated that "Pula" means rain which follows from the fact that almost three quarters of the land in Botswana was a desert. Her presentation focused on asset allocation and portfolio optimisation aligned to the establishment of the Pula Fund; and the governance institutional framework.

She pointed out that Botswana as a landlocked country in southern Africa, has a small open economy, typical of a commodity rich developing country. It has a narrow domestic economic base. Botswana is the world's leading diamond exporter and the accumulation of diamond export receipts has contributed to fiscal surpluses over a number of years.

Currently, the country has a relatively high level of foreign exchange reserves compared to what prevails in other developing countries (currently at 20 months of import cover). The reserves used to be very high in absolute terms and capital flows, close to 40 months of import cover. This was affected negatively by the onset of financial crises in 2008 and 2009 and the ensuing recession that preceded the crises. Part of the country's export revenue is held as foreign currency reserves to yield additional foreign exchange income needed.

The currency is pegged to a basket of five currencies including the South African Rand and the SDR currencies (Yen, Pound, Euro and US dollar) in a crawling peg exchange rate. In this regard, there is no policy to accumulate reserves with a view to supporting

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[4]Mrs Linah Kelebogile Mohohlo is the Governor Bank of Botswana and is a member of the Commission for Africa. She is the current Chair of the MEFMI Executive Committee. She has worked for the International Monetary Fund (IMF) as a Special Appointee. Mrs Mohohlo serves on boards of major corporations in Botswana and abroad. She also served as a member of the Commission for Africa and is currently a member of the Bill & Melinda Gates Foundation's Committee on Financial Services for the Poor. She sits in the Investment Committee of the United Nations Joint Staff Pension Fund and has co-chaired the meeting of the World Economic Forum for Africa. Mrs Mohohlo is also a member of the Africa Progress Panel (APP). She is a recipient of a number of national and international awards, among which is Botswana's highest public service award for efficient and devoted service, the Presidential Order of Honour; both the Financial Times Magazine (The Banker) and Euromoney bestowed on her the Central Bank Governor of the Year for Africa Award in 2001 and 2003, respectively. She has read accounting and business, economics, finance and investments at the University of Botswana, The George Washington University and University of Exeter, respectively, and received executive management training from Yale University. Mrs Mohohlo has authored and published several papers and book chapters in economics, finance/investments, reserves management and governance.

the exchange rate, as supporting the currency, which would be the case in a floating exchange rate. Therefore supporting the currency is not one of the objectives of accumulating foreign exchange reserves in Botswana.

A. Tranching
She pointed out that as a developing country that is vulnerable to a number of shocks, it is advisable to hold relatively high reserves, if possible, given the impact of adverse exogenous factors. For example, in Botswana's case, it is a relatively undiversified economy, relying mainly on extraction and export of a non-renewable commodity-diamonds.

The country's terms of trade depend to a substantial degree on real exchange rate between ZAR and SDR. It is susceptible to periods of sustained drought and geopolitical uncertainties.

Against this background, the authorities decided to manage reserves in partitions. In order to reflect different objectives and risk/return preferences. Two (2) tranches were established namely; the **Liquidity Portfolio** and the **Pula Fund.**

i The Liquidity Portfolio
The Liquidity Portfolio is a portfolio of reserves which is typical of the reserves that are managed at the central bank, used as a back-up against short-term trade and capital account fluctuations and sales in case there is need to finance adverse developments in the external payments situation. There are two (2) portfolios under this category namely;

- Transactions Balance Tranche – basically a checking account used for cash management to stem inflows and outflows.

- Liquidity Investment Tranche – a typical investment portfolio of the central bank which tends to confine its exposure to fixed income investment instruments.

Regarding the legal aspects, she pointed out that there are specific levels of reserves needed under this portfolio. It was agreed that for purposes of ensuring that there is sufficient cushion to allow government to meet its liquidity obligations, six (6) months of import cover is kept under the portfolio, though currently, Botswana has fourteen (14) months of imports of goods and services under the fund in long dated investments such as bonds and equities.

ii Pula Fund
The Pula Fund was established in 1993 with the following main objectives:
- To ensure that national savings are deployed in a manner that contributes to sustainable economic development;

- To the extent that Botswana cannot absorb the available financial resources for productive purposes, without distorting domestic prices, long-term offshore investments needed to be considered very seriously to deflect demand for immediate use of resources and for possible unproductive/unsustainable projects which in some cases may not be included in the national development plans or have not been appropriately evaluated as is the case;

- The fund was established to generate relatively higher returns than possible in short-term investment instruments;

- It is the country's additional long-term earner of foreign exchange;

- Form of diversifying sources of income away from dominant commodity export income to include financial investment income; and

- It is considered a prudent yield maximising alternative.

Objectives or principles of safety, return and liquidity
Accordingly, investment policies had to be refined and prioritized such that:

- Safety occupies the first position of maintenance of value/purchasing power on a continuous basis;

- Return occupies second position given the importance of generating additional foreign exchange on a continuous basis; and

- Liquidity comes third, since the Pula Fund can tolerate short-term volatility in view of its longer investment horizon.

With regards to investment policies, investment guidelines were also put together as procedures for implementing investment policies. In addition to gathering for risks associated with eligible investment currencies, interest rate risks, market risks, credit risks or the issue of countries obtaining credit ratings, the guidelines also contain performance targets and benchmarks for respective mandates.

B. Asset Allocation and Portfolio Optimisation
The policies would be based on the three (3) objectives or principles of safety, return and liquidity. Once it was agreed that the Pula Fund be established, it became imperative to engage in asset allocation and portfolio optimisation processes.

The process itself meant that the optimization exercise considers:

- The nature of capital markets;
- The relative risk/return profile of asset classes; and
- The negatively correlated asset classes to achieve diversified portfolios of bonds and equities.

The exposure of the Pula Fund in terms of equities is in North America, Europe, UK and some parts of the Pacific Basin.

With regards to the Pula Fund Asset Allocation Model, the Bank:

- Quantified effects of diversification;
- Identified investment asset mixes constituting efficient portfolios; and
- Determined expected return & risk of portfolio using input assumptions of:
- Expected Return;
- Standard Deviation/Risk of expected return; and
- Correlation Coefficients (relationship between pairs of investment asset classes).

The input assumptions were considered sound and consistent with long-term historical capital market returns.

A series of tests of sensitivity of these results to changes in input assumptions were also conducted in the best interests of a robust analysis as shown in Chart 15 below:

Chart 15: Input Assumptions (Percent)

Asset Class	A	B	C	D	E	F	G	H
Fixed Income	100	80	70	60	50	40	30	0
Equities	0	20	30	40	50	60	70	100
Expected Return	3.2	3.7	4	4.2	4.4	4.6	4.8	5.6
Risk	3.2	4.1	4.5	5.2	6	7	7.9	11.5

Source: Bank of Botswana

Hence, outcome in Chart 15 (Portfolios B to G), where risk and expected return increase as portfolios are diversified to include equities.

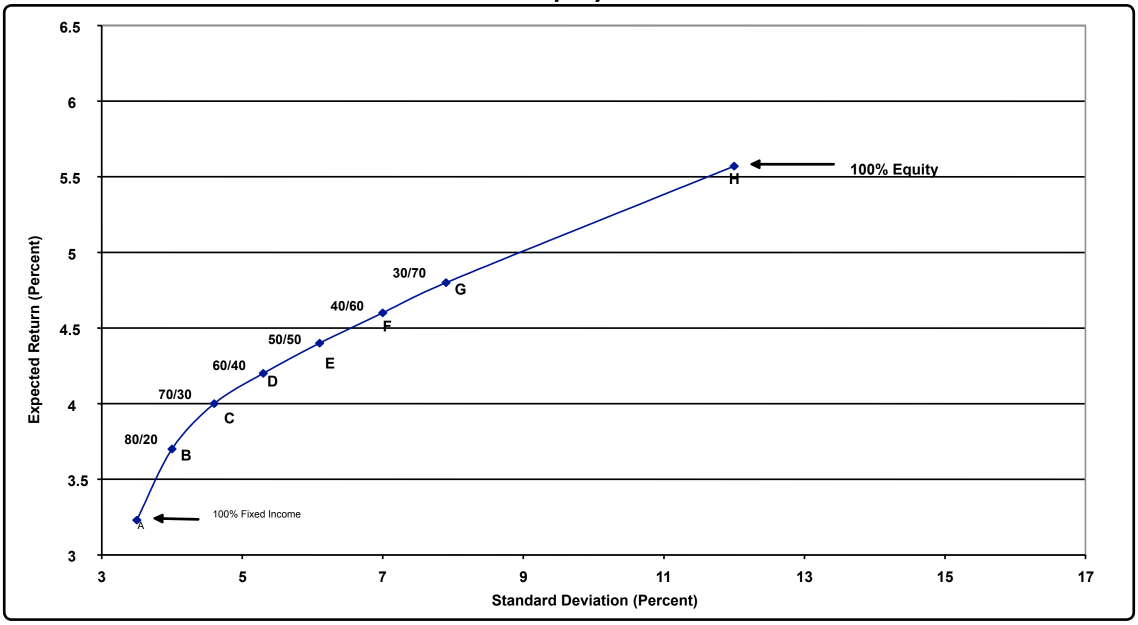
It is important to note that the increase in return is less than the increase in risk as long-term assets (equities) are added to portfolios. That is, if there is movement from the left to the right, there will be movement at a line of expected return and engage in equity down from risk free portfolio or 100% fixed income all the way to 100% equities. In between, there are combinations of these portfolios.

The increase in risks as you move in a combination of portfolios, as you move to the right, is higher than the risks in return. An investor will therefore make judgement on the determination of the relevant combinations given the exposure of the investor.

Efficient Frontier – Fixed Income/Equity Portfolios

Chart 16 below is a different representation from Chart 15 above, and it is still the portfolios from A to H meaning 100% fixed income to the extreme end where all investments are in equities. Countries have to place their investments somewhere where they will be able to explain to the authorities in a portfolio of a variety of investment horizons.

Chart 16: Efficient FrontierFixed Income/Equity Portfolios



Source: Bank of Botswana

The figure depicts:

- Series of efficient portfolios for every level of risk;
- Portfolios that maximizes expected return at each level of risk which the investor can select;
- In other words, the higher the standard deviation or risk, the higher the expected return as the efficient frontier tends to take an upward sloping curve; and
- The choice of efficient portfolio depends on the **investment horizon**, **appetite for risk** and **expected return** that the investor is willing to attain.

Probability of Missing Targeted Expected Returns

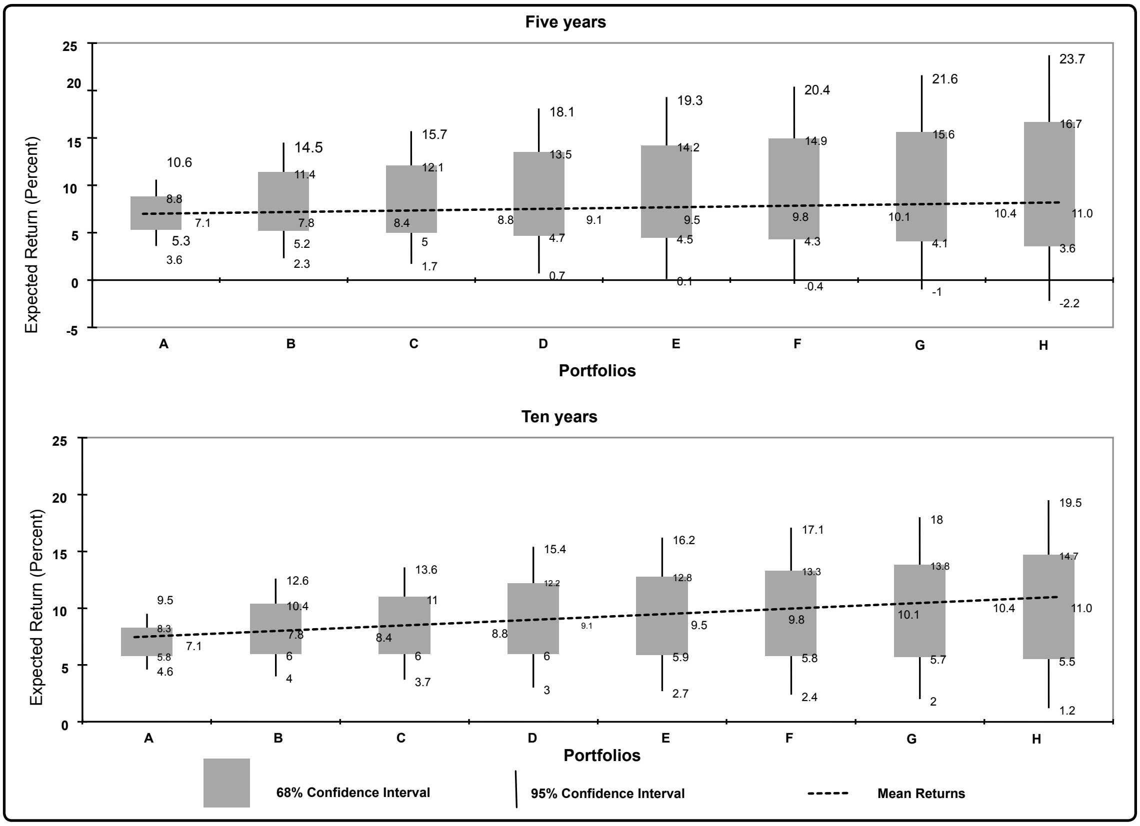
The next step on the asset allocation and full optimisation exercise is the assessment of probabilities of expected returns of efficient portfolios as a guide to determine an appropriate portfolio choice.

For example, the horizontal broken line in Chart 17 below shows the probability of expected return for each portfolio. At each point of A to H, there is a **mean** expected return. An investor/country can settle for the mean return.

The shaded area is the 68% confidence interval. This means 68% of the time, for portfolio A, the return may likely be between 5.3%and 8.8%. For portfolio C, with 68% confidence interval, an investor can settle for a range of between 5% and 12.1% for a five (5) year investment horizon.

For a ten (10) year horizon, which is typical of a period that a SWF is looking to, for portfolio A, the confidence interval of 68%, enables an investor to expect of 5.8% and 8.3% and for portfolio C, it is a range between 6% and 11%.

Chart 17: Probabilities of Expected Returns - Efficient Portfolio



Source: Bank of Botswana

For the vertical line that shows 95% confidence interval, over a ten (10) year investment horizon, for portfolio C, an investor can expect anything between 3.7% and 13.6%.

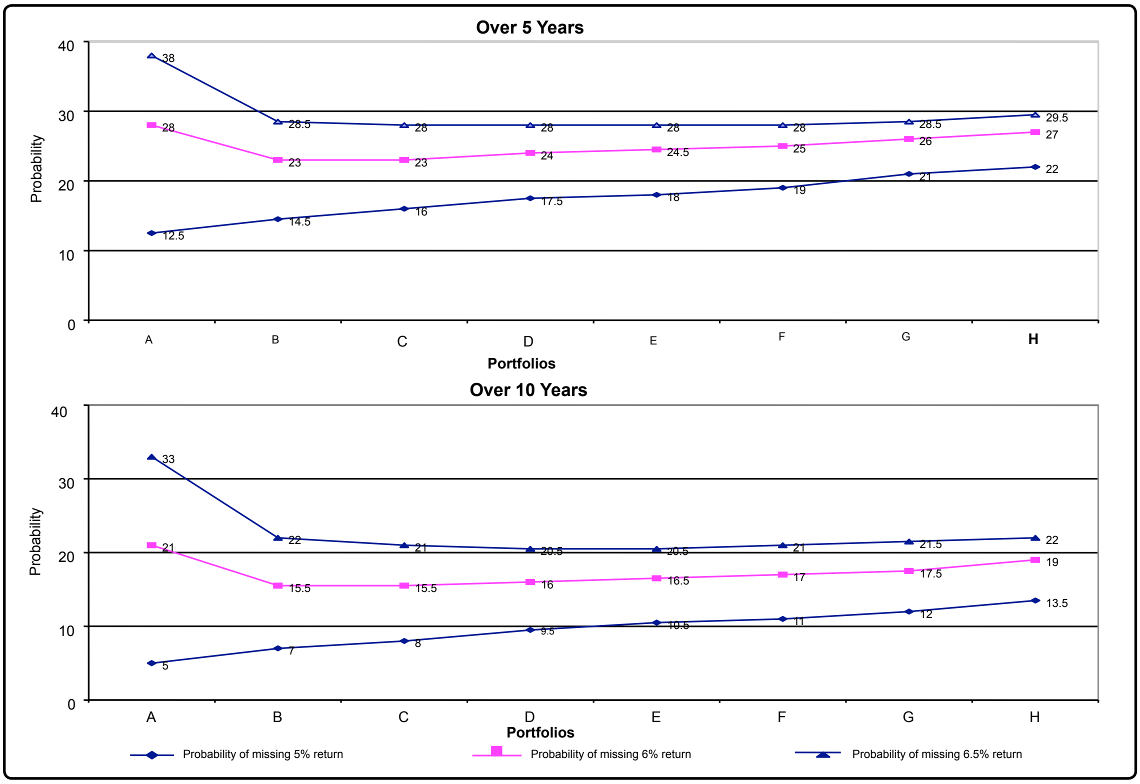
To illustrate the difference between a short-term and a long-term horizon, in the five (5) year investment horizon, for portfolio H, an investor can hope to make 23.7 % but at the same time, the bottom end is negative 2.2%. So as investors/countries consider these exposures, an investor must be quite sure where he or she wants to play in terms of expected return. The optimization exercise is able to expose these scenarios.

In Chart 18 below, the probabilities of missing targeted returns are higher in shorter-term investment horizon (5 years) and lower in longer-term investment horizon (10 years).

The top line connotes a 6.5% expected return across different portfolios. The probability of failing to achieve a certain targeted return is 38 on portfolio A. For a longer investment horizon, the probability of failing to achieve the intended target is 33 and is different across portfolios.

All the information has to be available to the investor to make a judgment on exactly what they want to do in choosing an ultimate efficient portfolio. This can only be one and not several.

Chart 18: Probability of Failing to Achieve Target Rates of Expected Return (SDR)



Source: Bank of Botswana

Efficient Portfolio

Against this background, given that there is an element of compensation in terms of higher return when additional risk is assumed and that risk tends to decline over a longer investment horizon, it made logical sense to confirm decision to establish Pula Fund and choose a particular "Efficient Portfolio" with limited downside risk of expected return.

For example, Chart 17 above shows that portfolio B and C at 95% levels have probability for return range of 4 - 12.6% and 3.7 - 13.6%, respectively over a ten (10) year investment horizon.

C. Governance / Institutional Arrangements

Governor Mohohlo noted that the Bank of Botswana is responsible for reserves management business. The Board of the Bank decides on broad policy and delegates implementation to the Governor.

The Ministry of Finance is intimately consulted on asset allocation, that is, the size of Liquidity Portfolio, which is six (6) months of import cover and the residual in the Pula Fund.

The Bank communicates with the ministry so that they have information on the proportions for fixed income/equity in the Pula Fund which is a function of portfolio optimization exercise.

There are many departments of the Bank of Botswana with various roles.

Financial Markets Department

The Department manages by agreement of the Board, 50% of reserves only in fixed income mandates of Liquidity Portfolio and Pula Fund. The other 50% is managed by nine (9) external fund managers also in fixed income and exclusively the management of equity mandates of Liquidity Portfolio and Pula Fund. There are six (6) mandates: Fixed Income and Equities (Global Balanced, European, UK, Japan, US). A combination is chosen so that a balance is achieved which will provide a favourable return. Diversification is achieved through asset allocation and implied choice of investment instruments and by geographic exposure.

Reasons for appointing fund managers

- Performance comparison;
- Staff training. Staff have to continue to learn from experts through attachment to their offices and continuous exchange of information on financial markets;
- Fall-back position in case of brain drain; and
- Provide added value incremental to portfolio.

Criteria for appointing fund managers

- Investment expertise;
- Experience;
- Stability;
- Investment style;
- Decision-making process;
- Past performance (though not always a predictor of future performance);
- Willingness to train Bank Staff; and
- Fees charged (not the main factor).

Custody service (since 1993)

- Monitor investment activity;
- Provide audit trail - checks and balances to all the asset managers including internal managers;
- Transition management (in case of appointment of a new manager or termination of existing manager and if there is need for portfolio rebalancing);
- Performance Measurement (including performance attribution analysis); and
- Securities Lending (if an investor wants to opt for it).

Conclusion

Governor Mohohlo pointed out that the Bank of Botswana believes that reserves must be actively and conservatively managed in best national interest, in two distinct tranches, one of which is the long-term fund for future generations, Pula Fund - akin to a Sovereign Wealth Fund.

She underscored that Botswana is Santiago Principles compliant, established jointly by IMF and group of SWFs (2008), with Botswana being one of the founding members and current Secretary.

Discussions

Prof. Ndulu noted that the presentation offered some practical advice. The experience shared gave delegates insight into the choices at the disposal of policy makers on how to effectively use a central bank or independent external fund managers for managing financial resources attained from natural resources. He noted that the Bank of Botswana is an example of a central bank that has done extremely well in managing a fund.

Honourable Willard Manungo, Secretary to the Treasury, Ministry of Finance and Economic Development, Zimbabwe sought clarification on the case of external fund managers with regards to the timeframe that they are given as well as on how outflows (surpluses) from the fund are determined and made available.

Governor Mohohlo noted that there is no timeframe for external fund managers; rather it is a business relationship. She underscored that with the service providers that offer custodial services, there is no notice for cancelling the relationship with external fund managers.

She clarified that the fund managers are not in custody of money but are only responsible for investing. Therefore if a decision is made against one, the portfolio is parcelled out anytime. She noted that there is no timeframe and they only require the experts to fulfil their mandates. She also noted that they engage the best fund manager in the world (Ivy League). In their choice, experience is critical and they have to have been in practice for a many years.

Regarding outflows, she pointed out that there are trigger mechanisms which enable the Bank to access the Pula Fund in order to beef up the Liquidity Portfolio so that it is six (6) months of import cover. Similarly, if the liquidity portfolio is in excess of six (6) months, there is also a process that is followed, to take away money into the long-term fund. The process takes some time since the Bank cannot always access the funds for future generations without making a significant case.

She further observed that in addition to this, on an annual basis, the Bank makes some provisional forecasts to determine the expected return in investing the funds and uses it to make a promise to the government on the size of the cheque they are likely to receive.

If there is out-performance, the government takes what was promised and the remainder is credited to government coffers as well. Should it be short, the account is accessed. The rules and regulations have worked since establishment in 1993.

Prof. Ndulu sought further clarification on the extent to which the decline of import cover from 40 months to 20 months was driven by expansion of imports rather than simply outflows.

Governor Mohohlo stated that a significant amount is attributed to the growth of imports. This has to do with the fact that at the onset of the financial crises, there were large developments of infrastructure which raised capital expenditure.

Furthermore, Botswana also closed the biggest mine so that they do not stock pile diamonds now that the prices are depressed. The government has been conscious not to produce at excessive levels since diamonds are a luxury item that is not bought during difficult times. These factors have affected the level of foreign exchange reserves over the years.

Dr. Desire M. Sibanda, Secretary for Zimbabwe Ministry of Macroeconomics & Investment Promotion sought clarification on the assurance to the public on financial accountability and audit. That is, whether it was government audit or commercial audit that was engaged.

Governor Mohohlo stated that the Bank does reach out to stakeholders. She pointed out that the Bank of Botswana publishes its balance sheet on a monthly basis which has partitions on foreign exchange, Liquidity Portfolio and the Pula Fund and the citizens are able to determine the levels.

With regards to informing stakeholders, she said that the Bank also conducts economic briefings conducted at the time of publication of the Annual Report of the Bank which contains the state of the economy and Bank plans. It also includes status of reserves management for members of parliament, the president and members of cabinet, business community and special interest groups such as women’s groups.

The parliamentary sub-committee looks at the conduct of quasi government institutions including the Bank which is in charge of reserves management. Therefore the Bank believes that outreach is appropriate.

2.5 SESSION 5: MANAGING AFRICA'S REVENUES: IN SEARCH OF STABILITY AND DIVERSIFICATION

This presentation was made by Mr. Malan Rietveld[5] and moderated by Mr. Jean Ciza, Governor, of the Bank of Burundi.

Governor Ciza stated that the MEFMI region is endowed with natural resources and what is of great importance is to have strategies that will assist countries in effectively managing funds realised from natural resources. Prudent management should transform countries in the Africa region. He encouraged policy makers to study the case of Botswana.

Mr. Rietveld pointed out that Investec had done some work with the Harvard Kennedy School of Government for two years on the topic of profiling countries' sovereign SWFs. He stated that the total assets under management of SWFs including Saudi Arabia, Hong Kong Monetary Agency investment portfolio globally, are estimated at US$7 trillion but a conservative definition of SWFs places them at about US$4 trillion.

He observed that the interesting issue about SWFs is that it is both a rich and a poor country club. Among the richest countries with SWFs are Norway, some Provinces of Canada and some states of the United States of America (USA). East Timor and Papua New Guinea are among the poorest countries with SWFs. He also noted that there are SWFs in some African countries.

He stated that SWFs have been in existence for a very long time with those for Kuwait and Saudi Arabia, having been created in the middle of the 21st Century while some funds that are included as SWFs from a number of American states such as in Alabama and New Mexico that were created at the end of the 19th century are still in existence and their proceeds are used to fund budget items.

Recent developments show that there has been a proliferation of SWFs since the 2000s and includes funds in Asia arising from excess foreign exchange receipts resulting from monetary and exchange rate policies but the largest part are from countries that are rich in natural resources.

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[5]Malan Rietveld is the Director of the Investment Institute. His focus is on policies towards investment around the extractive industries, including resource-related infrastructure, foreign direct investment and the management of resource revenues. 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. Prior to that he worked at Central Banking Publications and the Official Monetary and Financial Institutions Forum in London. He is the editor of three books on sovereign wealth funds: Sovereign Wealth Management (with Jennifer Johnson-Calari), New Perspectives on Sovereign Asset Management and Sovereign Risk Management.

Malan holds an M.Sc in Economics from the University of Leuven and an M.Sc 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.

He stated that Investec has had a long-running partnership with the Harvard Kennedy School of Government and working particularly with Professor Ricardo Hausmann, who has done a lot of work in the area of management of natural resources revenues and resource based economies; He also has hands on experience as the former Minister for Economic Planning in Venezuela.

Investec also worked with Dr. Khalid Al Sweilem, another scholar at Harvard, who for 21 years managed the investment portfolio of the Saudi Arabian Monetary Agency and oversaw the growth of the pool of assets to over US$850 billion. The study produced three (3) reports. The first report was a profile of 15 Sovereign investors using a consistent framework, covering:

- 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 how money flow out of the fund; and
- The governance structures and a little on the investment style.

Not all the countries looked at were strictly SWFs but all fall within the broad category of sovereign investors.

The second report covered how to establish and potentially reform existing SWFs. The report included:

- The definition of all the different kinds of sovereign investors, the different kinds of SWFs within that broader category, some of the basic rules that are in place in different countries including transferring revenue into the fund. It was found that in most cases these rules are at best second best solutions;
- How countries should think about saving, spending and stabilisation needs;
- There were also a few chapters which introduced and applied a bigger model that looks at all these decisions in one single framework; and
- Finally the report looked at different issues around governance structure, particularly the establishment and governance of rules that govern the flow of assets and funds into and from SWFs, the role of the board, the composition structure of the board and whether assets are better managed within the central bank and under which conditions that could be the case and when it makes sense to establish an independent investment authority.

He stated that together with Dr. Khalid Al Sweilem, they applied these ideas on Saudi Arabia case and came up with surprising cases underlying the problems that Saudi Arabia faces notwithstanding that at one time they had accumulated US$850 billion in assets before it adopted a formal rules- based framework.

Purpose of SWFs in Natural Resource Economies

Mr Rietveld stated that Adam Smith in his famous book "***The Wealth of Nations"*** described mining or commodities in general as ***"the most disadvantageous lottery in the world"***. This comes to point that prices are completely unpredictable, and several studies have shown the behaviour of real price of oil exhibits random work behaviour. They are correlated to all kinds of production uncertainties. From these facts, a number of functions have been allocated to SWFs.

i Macroeconomic and Fiscal Stabilization

Key objective is to assist governments in decoupling their spending from the underlying commodity revenue cycle.

ii Saving

Savings because countries are anticipating future spending needs or as an endowment for future generations, replace a depleting natural asset/income with a financial asset, produce a stable and diversified source of revenue to government (pure locked up funds for future and income generating funds).

iii Preventing Dutch Disease

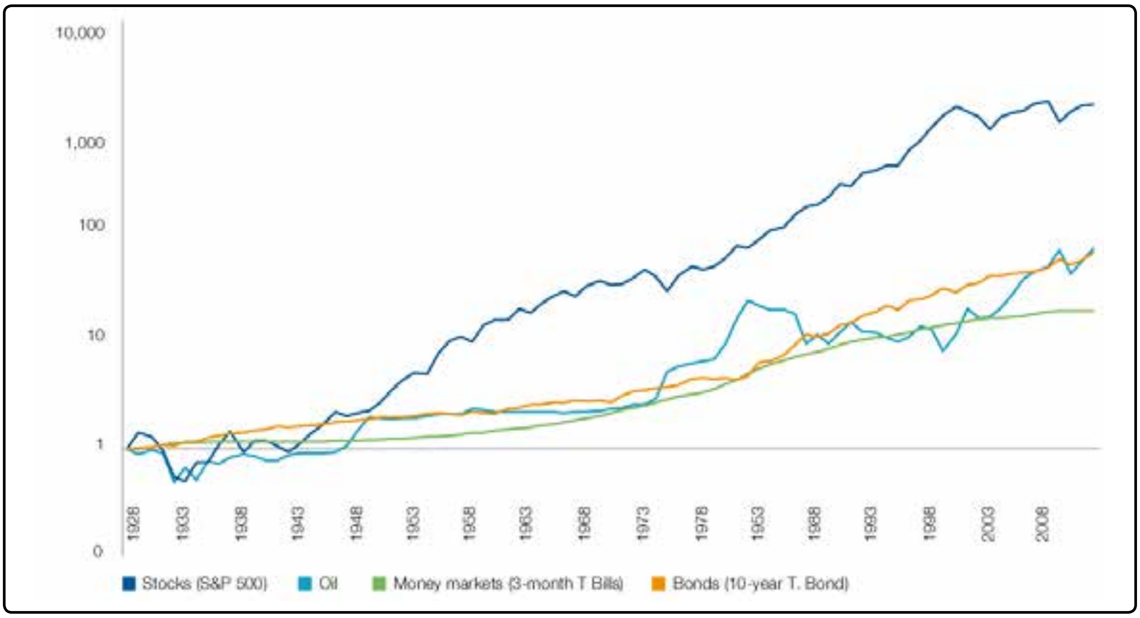
Resource boom can lead to sectorial misallocation of resources and capital, real-exchange rate appreciation and lose of non-resource export competitiveness. This is explicitly the reason why a number of SWFs apportion their proceeds abroad.

iv "Sovereign Risk Management" and Revenue Diversification

This is based on Norwegian philosophy of transforming oil to equities (or financial assets). It does not have to be equities alone. From a sovereign portfolio perspective, return to equities has performed better than oil over time since 1928, considering the high volatility of oil prices and that transformation of oil to equities has been profitable to them.

In was noted that on their risk calculation, Norway evaluate the risk of oil in the ground given the volatility that oil prices exhibit verses the assets they own in SWFs, currently approaching a trillion. They see a lot of volatility in their sub-soil assets than in the SWFs assets as illustrated in Chart 19 below.

Chart 19: The Norwegian case for saving: "oil to equities"



Source: Investec

Mr. Rietveld highlighted three (3) principle questions that must be considered in deciding to establish SWFs:

- What are the savings meant for;
- How and how much and under what conditions are assets transferred into the SWFs;
- Decide on the different types of SWFs: saving and stabilisation.

Secondly, the critical question is the spending rule. How much is transferred from the SWFs. There is need for a different policy for the saving, separate from the policies on stabilisation and income fund.

Thirdly, the critical issue is how to do things in a simple and transparent manner on the investment side. This involves the choice of in-house or external asset management etc.

SWFs and Savings
Which policies do countries adopt for transferring some portion of their revenue into the SWFs.

- A number of countries still use very simple policies where they transfer fixed percentage for example, saving 10%, 20% or 50 % of their revenue annually into the fund. The advantage of this approach is that it is incredibly simple to understand, but the problem is that if it is done consistently, it must be done in tough times as it is done in the good times. There are no macroeconomic reasons for determining which percentages are appropriate, including during the burst cycle. Thus, this rule has the advantage of simplicity but is at the very bottom of all.

- Other countries have adopted a methodology based on moving averages. They calculate a moving average of say the first (4) or five (5) years of resource revenue and revenue exceeding that average in a particular year is transferred to the fund. If revenue undershot the moving average price, they draw out of the SWF to support the budget.

- Another deviation of this is to establish an annual reference price of oil. For example US$75 per barrel, such that proceeds of prices higher than that are transferred into the fund and vice versa if revenue is undershot. The advantage of this method is that it is fairly simple and the complication is how to establish the reference price and particularly who establishes it and is it open to all kinds of manipulation if people want to spend the revenue and break the rule.

These are very simple rules of thumb measures. Both polices can be adopted for current discussion and application in African countries. Mr Rietveld stated that an overwhelming majority of countries, even the most established ones, are still following a variant of these very simple rules. He observed that the current slump in commodity prices is revealing one important aspect of these rules - that is the generality that they were worthwhile as accumulation rules in the last 15 years when the prices were rising - that allowed for saving. In the current environment, to have a robust and sustainable framework for drawing on the fund assets - these rules are not quite fit for the purpose any more.

The Case for Norway
One example of a rule based framework that allows spending and saving decisions to be taken together is that of Norway. Norway essentially saves 100% of oil revenues. They calculate the budget ignoring oil revenue and they run a deficit on the non-oil budget equivalent to the transfer that they will get from the fund. The transfer is based on what they believe is the long-run sustainable return, which is 4% real return. They, therefore, run a non-oil deficit equal to 4% of the SWF only and do not require accumulation of debt through proceeds of the wealth fund.

This rule cannot work in a country that is 90% or even 50% dependent on oil revenue because the non-oil budget deficit will be absolutely enormous. It is therefore a policy that works quite well if countries do not need massive spending from resource revenue and there are a number of countries like Norway where wealth account for 25% of resources while the rest is derived from taxes on citizens' operations and consumption.

Investec Model
Mr. Rietveld presented the framework developed with Professor Hausmann and the team at Harvard on how to design fiscal rules-based framework that integrates savings, stabilisation and spending decisions under one roof. This work is based on some advisory work that Prof. Hausmann has done in countries including Albania, Columbia and Kazakstan.

Investec has also received a lot of interest on establishment of recent funds including in Alaska to adopt some of the thinking in their framework.

Mr. Rietveld argued that the model allows countries to base different inputs and assumptions on the future trend of revenue, different spending rates, different returns on funds - to quantify the trade-offs that countries face in stabilisation, spending and savings.

He noted that countries will be doing themselves a disservice if they think of savings and spending in completely binary terms. It is a case of planting different trees in the financial universe and ensuring that countries can switch flexibility in the model.

The basic idea behind this rule is that countries will establish a stable spending path which is determined by three (3) fundamental factors[6]:

- The first factor in the model, is that spending for a particular year is based on some proportion of the previous year's spending, and all things being equal, countries will want to make this to be as high as it can possibly be, at least if there is some degree of saving, countries can save and spend approximately 70% of what was spent in the previous year.

- Then there are two additional sources of income, one is a transfer from a savings fund and the other is a transfer from a stabilization fund. The transfer from the savings fund from the model is based on what countries think as the expected long-term rate of real return, which is 4% in the case of Norway.

- The variations and shocks that countries encounter in the resource revenue from year to year are absorbed through the revenue from a stabilization fund. If countries have a good year and restrain themselves within the fiscal rule in order not to over spend, the stabilization fund will grow and even in a bad year countries can draw from the stabilization fund and maintain spending through a transfer from that stabilization fund.

The Case of Saudi Arabia

- Mr. Rietveld pointed out that Saudi Arabia is a country that is difficult to understand why there might be a problem. He noted that at the time of writing the report for the Saudi Government, they had US$850 billion of accumulated foreign assets held by the Saudi Arabia Monetary Agency. They also have an oil production outlook for at least 100 years. Similarly, the model of production is the lowest in the world, with a number of their wells producing at US$3 a barrel. Therefore, there is no doubt that Saudi Arabia will still receipt billions and trillions of dollars of oil revenue.

- However, they are faced at the same time by a number of problems. Chart 20 below shows calculations by IMF and rating agencies on the level of world prices needed to balance the budget in 2015, if expenditure is similar to 2014.

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

- Norway, Kuwait and Abu Dhabi are countries with massive SWFs but because they have implemented much more sustainable policies, they have accumulated much higher savings relative to their spending needs and they are able to balance the budget at US$40, US$54 and US$55, respectively.

- Saudi Arabia finds itself in a completely different category where it needs prices exceeding US$100 per barrel. At the current price of approximately US$50, they are running a budget deficit of US$150 billion in 2015.

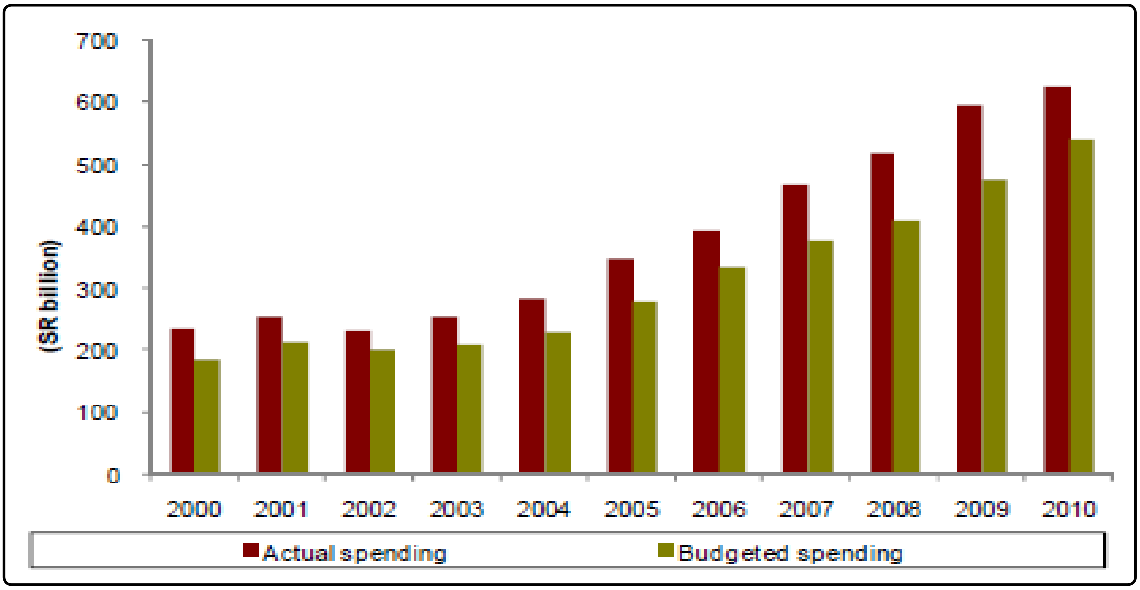
Chart 20: Saudi Arabia's Problems

COUNTRY	ESTIMATED OIL PRICE REQUIRED TO BALANCE 2015 BUDGET
Norway	$40
Kuwait	$54
Abu Dhabi	$55
Russia	$105
Saudi Arabia	$106
Nigeria	$122
Iran	$131
Algeria	$131
Venezuela	$160

Sources: International Monetary Fund (2014b), except for Nigeria, Russia and Venezuela (Deutsche Bank, 2014) and Norway (Fitch Ratings, 2014).

- The other factor is that they spent a great deal of their revenue over the past year and are not managing the budget process in as much as it is an oil rich country as shown Chart 21 below. Since 2000, when the price exceeded US$70, instead of saving, they have increased spending each year by 15 to 20%.

Chart 21: Saudi Arabia's problems: Budgeted and Actual Government Spending

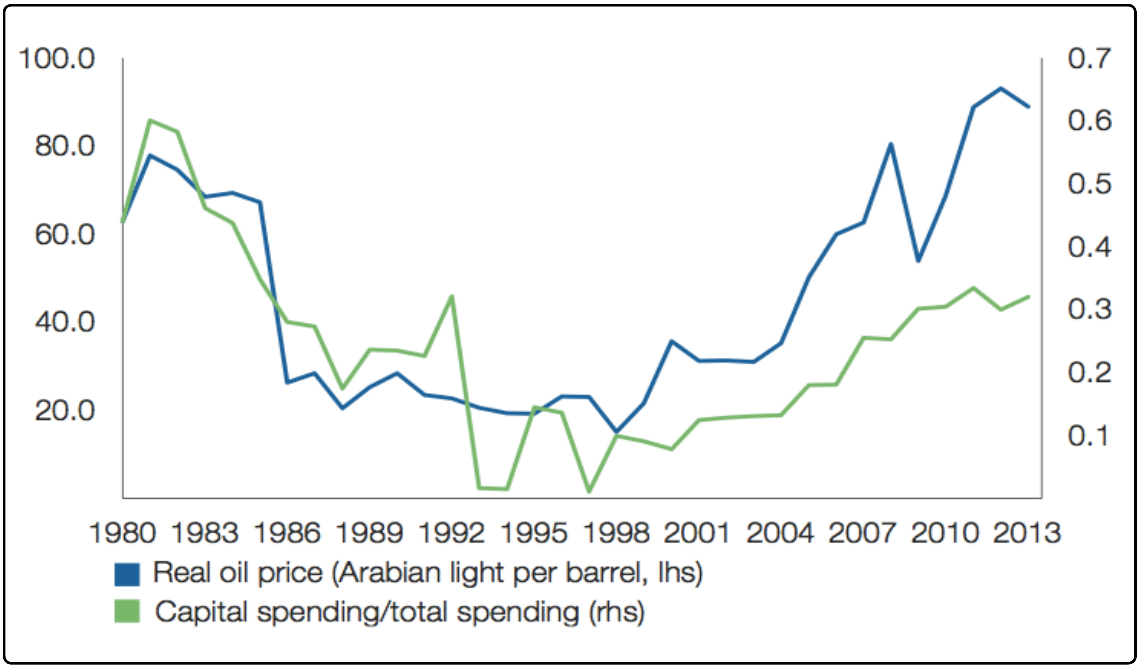


Source: Investec

- Similarly, over the long-term, capital spending in the economy has been tied to oil prices, which fluctuates in good and bad times.

- Furthermore, Chart 22 below, indicates that over the last couple of years not much has been done in capital spending. A great deal of spending has gone into financing unsustainable subsidies and public sector salaries. This is perhaps the biggest problem that Saudi Arabia is facing.

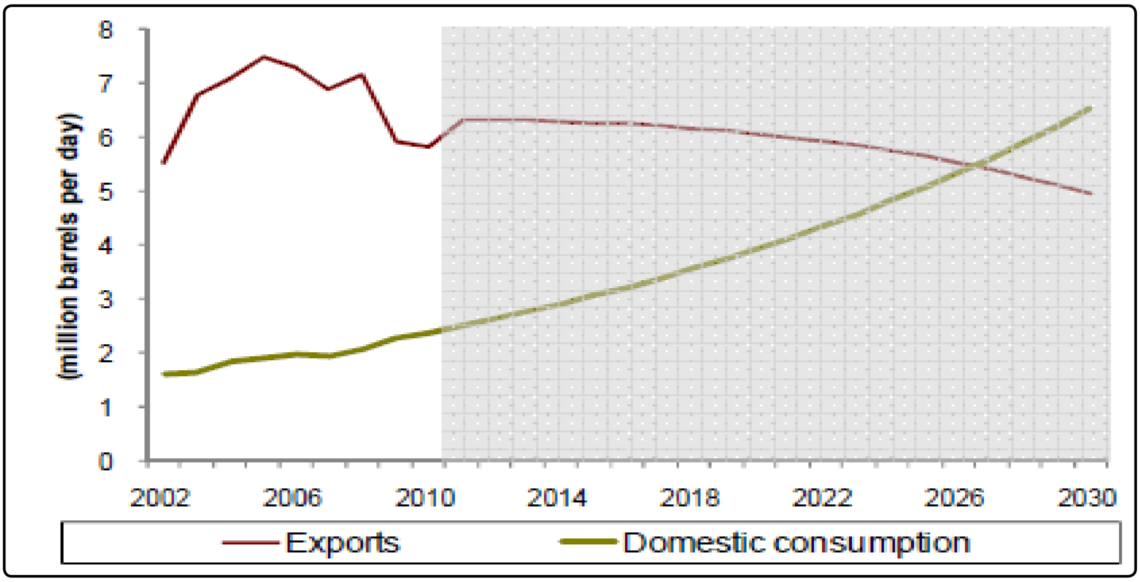
Chart 22: Saudi Arabia's problems



Source: Investec

- Domestic consumption of oil is high and subsidies are rising very strongly as indicated in Chart 23 below. If this is tied to the Saudi demographics, an aging population, some estimates are saying that in a little more than a decade, Saudi Arabia can actually import oil

Chart 23: Saudi Arabia's problems

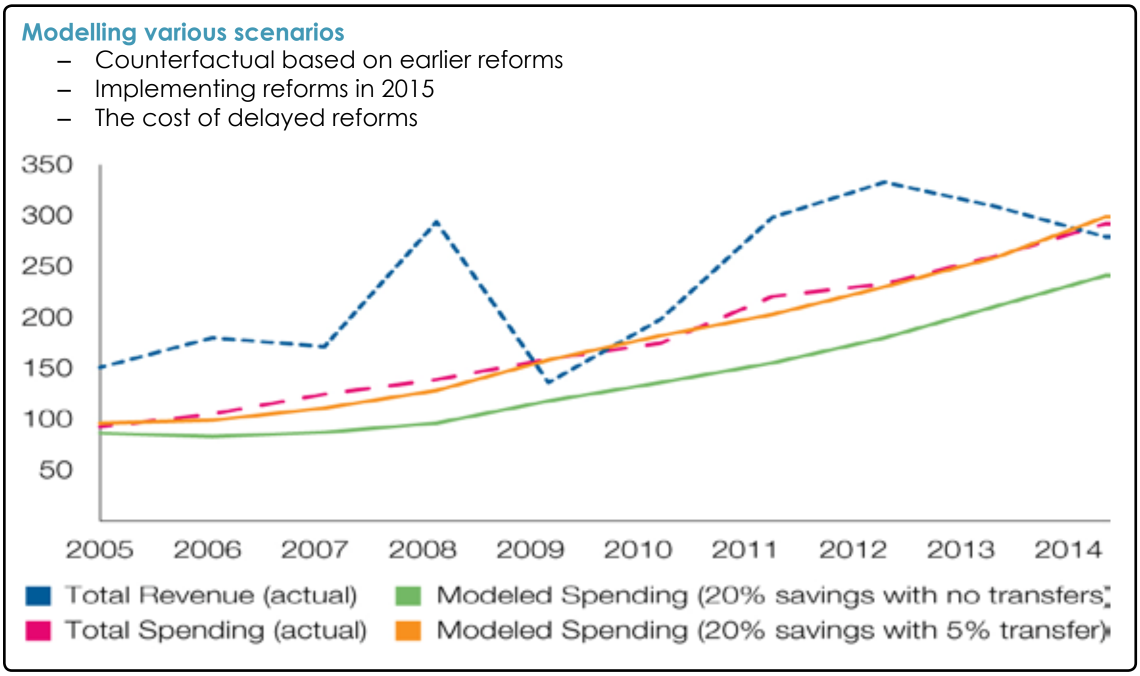


Source: Investec

Recommendations to Saudi Arabia

- Over the past 30 years there was need to have a conservative budget number, overspent by 20% and put what is left in the SWF as illustrated in Chart 24. This worked during the period when oil revenues were rising.

Chart 24– Actual vs. Modelled Spending/Revenue



Source: Investec

He noted that Saudi Arabia now needs a fully integrated and binding fiscal rules framework. The key issue presented to Saudi is the opportunity cost that they had of not saving enough from past booms starting in 2000.

The key message is that countries should not delay reforms. The longer countries wait - the harder and the more costly it gets.

Practically, it is assumed that Saudi Arabia mob-down from US$850 billion to US$750, having spent US$150 billion of accumulated assets in the past year. It is calculated that Saudi Arabia can:

- Put US$250bn as an initial capital to the stabilisation fund; and

- The remaining US$500bn in initial capital to the Saudi Future Generations Fund -long-term generating fund.

A number of recommendations were made around governance and institutional structures for Saudi Arabia. The arguments were:

- The stabilisation fund could remain with SAMA (central bank), reporting to Ministry of Finance.

- Future Generations Fund be managed by a new entity with a rules based framework, under the Governing Council - the Supreme Economic Council with an independent board of directors - independent with fixed-term appointments and independent investment authority - led by a senior executive with clearly articulated mandates from government.

The Role of SWFs in Development and Diversification

- The Role of Domestic Investment

The argument for domestic investments is a departure from the original SWF model of taking resource revenue out of the domestic economic system and creating an endowment that replaces oil and creating a stabilisation fund.

There are very good reasons why that model emerged including:

- Institutional capacity constraints in attempts to scale up domestic investment. Most countries felt or they experienced that they did not have the capacity and they decided that the best option is to create these funds;

- Dutch disease;

- Economic bottlenecks associated and rapid scale of investments; and

- Political economy. In the political economy of resource rich countries, this is a massive topic and there are so many problems for spending resource revenue in the local system compared with the alternative of creation of SWFs.

"Sovereign Development Funds" and "Strategic Investment Funds"

Poor countries are now shifting and developing the **"sovereign development funds"** model, most of them targeting investments in infrastructure, power, railway and ports that have specific catalytic investments for growth, economic development and diversification.

Richer countries are also talking about **"strategic investment funds"** investing in Hi-tech sectors with significant value addition such investing in ICT and going business as is with the case of Alaska Fund.

There is therefore an emergence of hybrid models with multiple structures and objectives. Angola and Nigeria are setting examples in the continent in this area. Similarly, the draft legislation for Uganda is a SWF that will have all three (3) objectives of stabilisation, savings/income generation and domestic investment funds.

There is no problem with these basic structures but the devil in the details is around how much money will get allocated to these three (3) funds, in what way, can the country solve all the political economy problems that they have within revenues domestically; and whether creating a SWF is just shifting the problem to another area.

The Economics of Complexity

Mr. Rietveld took participants through the findings of a body of research that he conducted with his colleagues at the Harvard Kennedy School on the Economics of Complexity or Complexity Economics. This is a new way of thinking about why countries grow, which countries are said to grow and where are the opportunities for countries to target some specific sectors and areas of their economies for growth.

The focus was to provide some ideas around how this framework or thinking can be used to inform the policy and investment practices of SWFs.

Why do some countries grow?

The mystery of why some countries grow and some do not, why some countries grow for some period and then experience slowdowns or why countries have stagnant growth for decades is largely unsolved.

There are a number of theories and arguments for these and none of them has won the day. Economists argue that there is a bit of everything but the basic arguments are:

- **Classical Factor-Driven Convergence**: Countries with low levels of labour participation and capital can experience rapid capital growth, have high returns and drive convergence ("catch up" growth) due to their scarcity. Most countries in Africa can experience rapid capital convergence growth if they get other factors of the story right. This does not provide the arguments to sustain growth once this has been achieved;

- **Quality of Institutions**: Countries grow because of strong, democratic institutions: rule of law, broad-based participation, lack of corruption and protection of property rights etc.;

- **Arguments on Geography and Natural Resources**: Countries grow (or do not) because of geographical positioning – access to trading routes, fertile land etc. and natural resources endowment. It is argued that landlocked countries tend to grow slower than countries that have access to sea ports;

- **Education and Human capital:** There are arguments that emphasise on education, growth of human capital and health of a nation's population - drives productive capacity and therefore growth trajectories; and

- **Exports and Production:** This is the basis of the Economics of Complexity. That is, what a country exports and what can be learnt from countries production capabilities based on exports. Economic Complexity focuses on this aspect by determining a country's growth as a country' productive knowledge and the expansion of that production knowledge. The implication of this is that production capability of a country develops gradually and there is no very quick way. It is a slow and incremental process which is important for the discussion on how, when and over what horizon to spend resource revenue, the fundamental drivers of economic growth for slow moving growth. It is dangerous to anticipate achieving growth miracles by spending resource revenue.

Economic Complexity Theory
Using data on countries' level of exports, the Harvard Kennedy School has done a couple of studies that show the distinct which the economic complexity on productive structure explains both the difference in the levels of economic development across countries and the pace of anticipated economic growth.

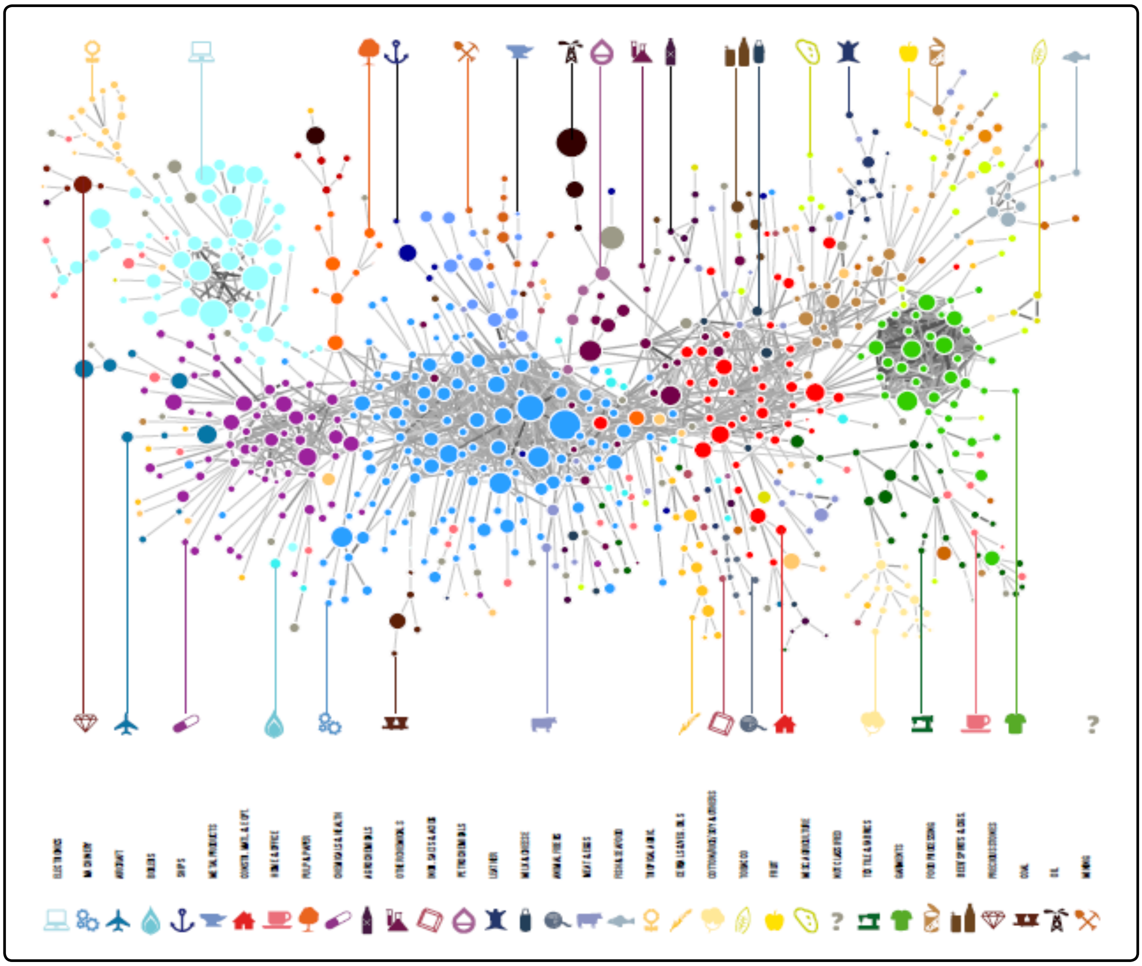
The work is collated in the book ***The Atlas of Economic Complexity***, which explains the intellectual foundations of this work, the methodology around the measurements and includes country data and key policy recommendations on which sectors to target.

Chart 25 below represents the productive structure of how an economy looks like and is called the product space. This includes clusters of products that are essentially tied to each other. The middle of the graph shows all the dots connected to each other. These are products that essentially occupy the same productive capability. If countries are able to produce a typical product and export, countries have the opportunity to move to adjacent or proximate products that apply the same sort of capabilities and skills.

Similarly, some of the products that are lying outside the range do not have a lot of linkages to other products. For instance, the skills and capabilities required to produce oil (which is far away from other products), does not require skills and capabilities to produce a number of other products. This is very important because a lot of resource rich countries are faced with capturing a greater share of the resource value chain, be more productive and diversify but the theory suggests that countries should capture revenue that they can get from it and look at some of the other things to do in the economy since oil is not a complex product and does not require massive production capabilities and is not well connected to other products.

In Chart 26 below, the correlation with the levels of per capita income is clear. The red line represents resource rich countries whose commodities exceed at least 10% of exports.

Chart 25: The Product Space

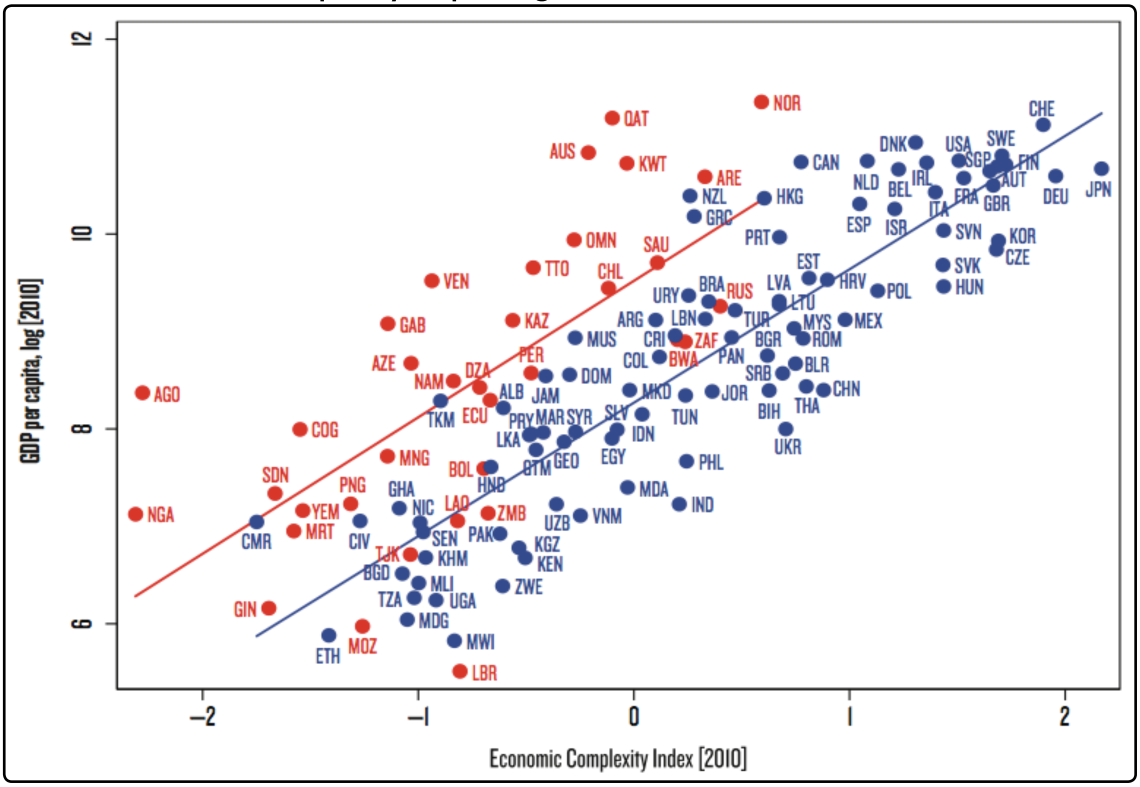


Source: Investec

Resource Rich and Poor Countries

All things remaining equal, for their level of economic complexity, resource rich countries tend to be richer than they should be. A number of countries have very low per capita income, given their level of economic complexity. This is a strong factor explaining per

Chart 26: Economic complexity: explaining wealth

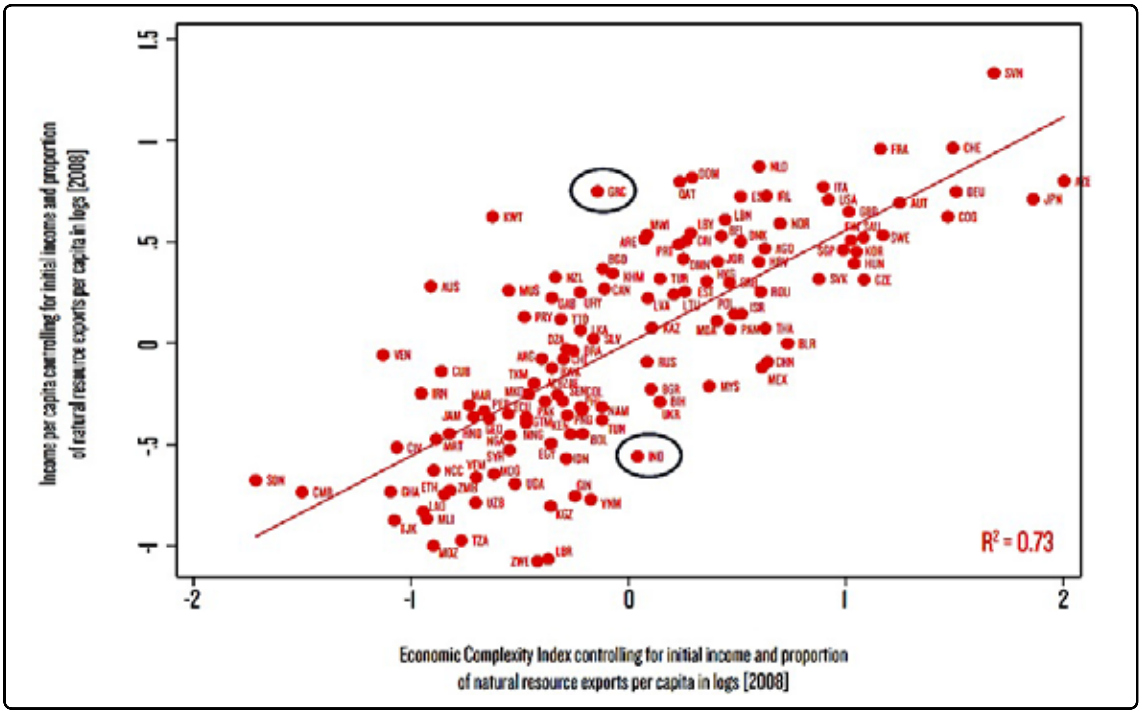


Source: Investec

capita levels of income across countries.

Future growth categories can also be predicted in this framework. In Chart 27 below, all countries were examined; measuring their economic complexities on the horizontal axis and their level of income. A line was drawn with the basic arguments that if a country is below the line, the country is not sufficiently rich, given the level of economic complexity. If a country is above the line, it is essentially too rich given the levels of economic complexity.

Chart 27: Economic complexity: predicting growth



Source: Investec

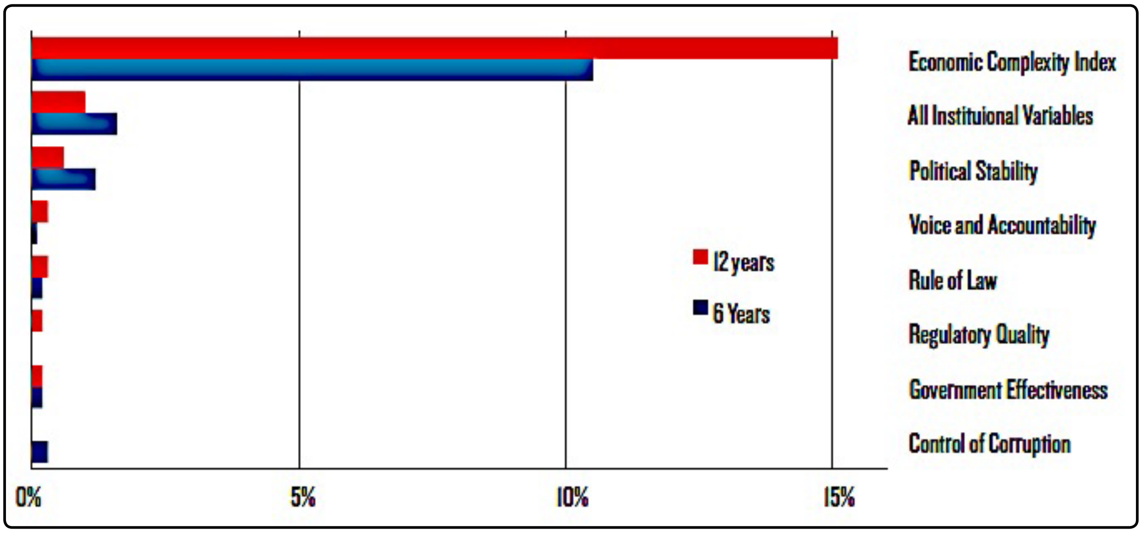
The Case of African Countries

For African countries, there is good news and bad news. African countries dominate the economies that are least complex and the good news is that almost all African countries are below the line which means they are expected to capitalise on the current productive capabilities to diversify and expand into new products.

The two countries that are circled represent those that come as the best (Greece) and worst (India) in terms of the Harvard studies predicted growth. At the top is Greece which is way too rich for its level of complexity while India at the bottom which is not where it should be in terms of its level of productive complexity.

In the report, econometric findings argue that in the typical cross country growth studies, the economic complexity variable do much better than all the other theories on which countries grow (such as institutional variables, education and other growth theories) illustrated in Chart 28 below.

Chart 28: Economic complexity: explanatory power



Source: Investec

The good news for Africa is that in the Harvard index of expected growth, eight (8) out of the top ten (10) expected to have the highest per capita growth from 2010 to 2020 are from Sub-Saharan Africa including six (6) from the MEFMI region as shown in Chart 29 below:

- Uganda, Kenya, Tanzania, Zimbabwe, Madagascar, Senegal, Malawi and Zambia
- South Africa and Nigeria, two (2) of Africa's largest economies, are expected to grow by 3.8% and 3.7%, respectively from 2010 to2020.

The bad news is that African economies typically have low levels of Economic Complexity.

RANKING 4. EXPECTED GDP GROWTH TO 2020									
RANK EXPECTED GDP GROWTH	REGIONAL RANK EXPECTED GDP GROWTH	COUNTRY NAME	ISO CODE	EXPECTED GDP GROWTH 2010-2020	GDP GROWTH 2000-2010	RANK INCOME 2010 [USD]	INCOME 2010 [USD]	EXPECTED POPULATION GROWTH	REGION
1	1/4	India	IND	7.0%	7.4%	101	1,375	1.3%	South Asia
2	1/26	Malawi	MWI	6.4%	4.7%	127	339	3.3%	Sub-Saharan Africa
3	2/26	Tanzania	TZA	6.1%	7.0%	121	527	3.1%	Sub-Saharan Africa
4	3/26	Liberia	LBR	6.1%	7.0%	128	247	2.6%	Sub-Saharan Africa
5	4/26	Kenya	KEN	6.0%	4.1%	117	795	2.6%	Sub-Saharan Africa
6	5/26	Uganda	UGA	5.8%	7.4%	122	515	3.1%	Sub-Saharan Africa
7	6/26	Madagascar	MDG	5.5%	2.6%	124	421	2.8%	Sub-Saharan Africa
8	7/26	Zimbabwe	ZWE	5.2%	-4.9%	120	595	2.1%	Sub-Saharan Africa
9	8/26	Mali	MLI	5.1%	5.7%	119	613	2.9%	Sub-Saharan Africa
10	9/26	Zambia	ZMB	5.1%	5.6%	104	1,253	3.2%	Sub-Saharan Africa
11	1/16	Egypt, Arab Rep.	EGY	5.0%	4.8%	90	2,698	1.6%	Middle East and North Africa
12	2/4	Pakistan	PAK	5.0%	4.6%	113	1,019	1.7%	South Asia
13	1/16	Philippines	PHL	5.0%	4.8%	94	2,140	1.6%	East Asia and Pacific
14	2/16	Vietnam	VNM	4.7%	7.3%	106	1,224	0.9%	East Asia and Pacific
15	3/16	China	CHN	4.6%	10.5%	74	4,433	0.3%	East Asia and Pacific
16	10/26	Mozambique	MOZ	4.5%	7.8%	125	394	2.2%	Sub-Saharan Africa
17	1/21	Guatemala	GTM	4.5%	3.3%	87	2,873	2.5%	Latin America and the Caribbean
18	4/16	Indonesia	IDN	4.4%	5.2%	85	2,952	0.9%	East Asia and Pacific
19	5/16	Thailand	THA	4.3%	4.3%	70	4,614	0.4%	East Asia and Pacific
20	1/27	Turkey	TUR	4.3%	3.9%	46	10,050	1.0%	Eastern Europe and Central Asia

Source: Investec

Wrap Up

In relation to SWFs, Mr Rietveld proposed that when countries are looking at domestic investment opportunities through the theory of Economic Complexity, they should determine the kind of products that are in current production, what the country is good at producing, the products and industries that are closest to what countries are currently doing and start with those industries.

He pointed out that he does not believe that countries can solve a great deal of their problems by using SWFs to make these investments roll and spin rather than through the budget. Spending through the budget is more transparent, more democratic and reduces some of the risks that countries confuse in SWFs.

There are counter arguments why countries need to put these money in a fund with a longer term horizon than in the budget process but these are tough questions that many countries and people arguing for Sovereign Development Fund models still need to answer.

Discussions

Honorable Ronald Simwinga, Permanent Secretary, Economic Management and Finance, Zambia, sought clarification on the spending rule. He stated that the presenter had provided various rule of thumb and his view was that the quantitative rule was a backward looking rule - which looks at what was spent in the last period and what is planned for spending from the saving and stabilization funds. He inquired whether there was a general rule which is economically informed in terms of macroeconomics, optimized using an underlying utility function and can apply to varied situations and across nations.

Mr. Rietveld pointed out that the quantitative rule does not have explicit micro-foundations neither does it articulate a utility function. However, the thinking is based on a utility function where the utility and objective of government is to have a stable spending path. He stated that the model quantified some countries where the spending growth model and other countries that have stable flat model bar, depending on their conditions and their needs but it does not have fully pledged micro-foundations.

With regards to the backward looking elements, he stated that a starting point is that countries cannot predict oil prices or revenue to be accrued. Hence, countries should avoid this aspect when planning the budget.

He further stated that the rule allows countries to be backward looking in the sense that their expenditure is based on previous year's spending. However, it is known that oil prices will be volatile in future and the rule addresses this in the sense that if countries have massively higher than expected oil revenue, spending growth grows gradually than what happens at the level of the SWFs, rather than the forecast revenue. Similarly, if oil prices are below the expected levels, spending is adjusted downwards. The adjustment process is gradual and through the SWFs rather than the budget process.

Honourable Armando Manuel, Minister of Finance, Angola observed that the presentation made reference to SWFs covering a wide range of functions and shared the experience of Angola.

He informed delegates that Angola created three (3) different and independent types of funds in which two (2) are accounts and one (1) is an institution. Of these, the initial one is the basic infrastructure fund which comprises of allocation of a specific number of oil barrels. From this fund, the country feeds the SWF-under the policy that as long as there is a surplus, additional resources are allocated to the SWF. Under environment of deficit, given the agenda to set up infrastructure, SWF will not have additional endowments.

He further stated that Angola had an established oil price differential fund which has the specific function of stabilisation. Given the importance of oil prices in the budget, the price differential goes to the fund. The reason behind this is to make hard to tap, the resources from the SWF fund and to make sure that those investments can be done in an effective manner since in a very short time it is likely that fluctuations in prices will push the economy to tap additional resources from the SWF.

He pointed out that Angola has realized that the scheme is more appropriate for countries which are setting these policies in a very short period of time and countries which still have significant problems in terms of economic bottlenecks unlike Norway and others which already have a significant number of private sector players, which is different from African economies.

He further noted that most African countries face constraints in mobilising additional resources and they normally move to international markets but still have reserves in those banks that could have been used to support the resource mobilization strategy. The question is therefore how can countries make their resource mobilization strategies more creative? He also inquired on how countries should save resources while they are faced with critical needs in terms of infrastructure, education particularly in those areas that countries need to create the environment to promote efficiencies. Honourable Armando Manuel further raised the issue that the country just graduated from low to middle income which has implications in mobilizing funds from international markets.

Mr. Reitveld pointed out that in the case of Angola, there was need for a separate and different institutional structure for the domestic fund. That is why it is established as an institution and the others are established as accounts. More generally, he observed that it is important to recognize that countries cannot have successful investments in the domestic economy without ensuring a credible and sustainable fiscal framework.

It was observed that the current oil price environment is very hard for resource and oil dependent countries to show that they have sustainable fiscal frameworks and that once there is access to liquidity from a stabilization fund, the key issue is to create income sources on assets to fund some of the recurrent expenses and infrastructure investments.

It was further observed that the additional assets and reserves earning had very low yields in the current environment and the probability of countries needing to draw from those funds if oil prices stay low in the next two or three years is very high. It is therefore important to maintain those liquidity funds even though sometimes it is hard to justify existence given negative rates of return and massive investment needs and hence the strategy in Angola is perfect and well-constructed.

Honourable Gatete sought information on how to use the funds or resources invested globally when mobilising resources in the market to leverage for better deals.

Mr. Rietveld stated that countries might want to consider restructuring their debt if it is excessive. They might also want to make some allocations to develop the domestic bond market. The use of resource revenue is to produce endurance and ensure that countries get better credit ratings in future.

On the budgeting process, he underscored that it is important that countries do not shift the problem that they have not been able to solve for decades through the budget process thinking that establishing a fund and building it can solve the problem. He pointed out that to solve the problem countries must have a commercial criterion on domestic investment and return targets. It was observed that in the case of Nigeria, it quite explicit that they are willing to tolerate a lower return on domestic investment because it is important for the diversification and development of the economy.

He further highlighted that with SWFs, countries must insist on very clear investment criteria in the domestic economy and think about every possible way to ensure that the fund is able to make long-term investments. He observed that the problem with the budget process is that it is too short term and cyclical and countries must make sure that SWFs do not suffer from this problem.

3. PANEL DISCUSSIONS: LESSONS AND WAY FORWARD

The panel discussion comprised six (6) panellists and was moderated by Mr. Patrick Mutimba, MEFMI Director Financial Sector Management Programme.

3.1 The Importance EY's Annual Investor Attractiveness Survey

Mr. Rohan Malik, is the EY Emerging Markets Leader-Global Government & Public Sector He is responsible for Government practice for EY globally, comprising of 20,000 experts. He was asked to expound on the importance of EY's annual investor attractiveness survey which also covers the African continent and some of the recommendations on value generation for the industries that obtain value from extractives.

Mr. Malik stated that that there was no single answer to the question as every situation and every country was unique and there can only be lessons learnt and applied retrospectively. He also stated that one of the questions he responded to recently is whether the African narrative has changed - has the story of Africa really changed? He noted that to him, the answer is no as the glass is half full or half empty. IMF forecast indicate that the eight (8) out of ten (10) fastest growing economies are in Africa.

Over the last five (5) years, EY has interviewed 500 Chief Executive Officers, most of them from Africa. He stated that their investment perception and climate still remains quite strong, but were cognisant of the possible challenges. For instance, 75 million people including youth or as much as one and a half times the population of South Africa are unemployed around the world, many of them are in Africa. The time bomb is that more than 350 million people or more than the combined population of the MEFMI region who are not in employment, training or education. He observed that the demographic dividend is becoming a real issue for policy makers in Africa which calls for the need to look at their responsibilities towards getting value from extractives. This was more so because policy makers depend largely on extractives to generate value.

With regards to the challenges and the solutions he identified three (3) issues:

- **Performance,** not only policy. He observed that when Norway decided to look at what they should do 20 years back in terms of the role of governments and the private sector - the question was how they can get the best performance out of their extractives. There were no sacred or holy cows. They spoke about how to get maximum value, what government should do, what it should not do and how they can bring in the private sector with the right policies and mechanisms. Thus, the starting point is policy outcomes which should drive the right mechanism on what countries should undertake as fiscal and extractive policy.

- The second issue is on **economic diversification** where he cited the example of Malaysia which started by linking the value from extractives since the 1980s into 12 sectors for economic diversifications. In this regard, the critical question is what can Africa do to directly link the decisions taken by policy makers into economic diversification for the future?

- The third issue is **trust** and **transparency** in view of US$500 billion in illegal cash outflows from Africa in the last decade, of which 50% is from extractives. The question was therefore how countries can build investor confidence. Countries need time bound transparent procedures as the real mechanism for action.

3.2 The Types of Trees or Programmes that Countries Can Focus on

The question to Mr. Jukka Pihlman Managing Director Head, Central Banks & Sovereign Wealth Funds Public Sector and Development Organizations, Standard Chartered Bank was on the types of trees or programmes that countries should focus on.

Mr. Pihlman noted that he was at the IMF when the Santiago principle started, and noted that they spent a lot of time defining SWFs. The key aspect is that there has to be foreign investors otherwise it would not qualify as a SWF. He noted that the key question is to identify the problem to be addressed through establishing SWFs or Sovereign Development Funds.

He observed that the problem at hand is in two dimensions: The project has to have a social impact and financial return. If the project has a very high financial return, theoretically, the private sector should be participating voluntarily, which was not the case. The other dimension was that around the world, the issue is not really lack of capital, but it is more about lack of investible projects.

He sought to know how Africa can mobilise the US$7 trillion of sovereign money for infrastructure development in the continent which are invested purely for financial reasons and pointed out that investors would be putting more money in Africa if there were enough bankable and investable projects.

He observed that while there were capital restrictions to invest in infrastructure projects, there would be more demand or appetite to invest in infrastructure projects by the banking sector as long as there were investible bankable projects. He observed that most projects are often delayed or selection is not good.

He stated that there is a lot that can be learnt from Asian countries who are mobilising private sector funds instead of setting up their own funds through ***Investment Alliance for Infrastructure*** run by actuaries, that have public sector Public Private Partnerships (PPP) seed money and run purely for financial returns. The critical issue is that governments have realised the need for improving project governance to make them more attractive to invest. Governments have set up a PPP centre, which is a kind of centre of excellence for public private partnership with emphasis on capacity building, project design and project implementation that are related. The multilaterals - World Bank, IFC Asia Construction, Investment Bank worked with the governments, advising and ensuring that private sector money and SWFs can actually be mobilised and utilised.

3.3 The Role of SWFS in achieving more Flexible Infrastructure Financing

Mr. Mutimba observed that the discussion on the PPP centre which needs the right structures has provoked a lot of thought in line with Mr. Reitveld presentation on the Atlas of Economic Complexity. He posed the question on the role of SWFs in achieving more flexible infrastructure financing in view of the assurance by Mr. Philman that the funds were available, more so given high demand in Africa.

Mr. Reitveld noted that if countries want SWFs to finance infrastructure in the domestic economy, a country needs to explain why that is happening in SWFs rather than in the budget. There could be many answers to this. One could be that the SWFs have a ten (10) year horizon while the budget has a one (1) year horizon. The other answer is that infrastructure investment requires real deal making private expertise which does not reside in the legislature but might reside in a dedicated sovereign development fund.

He, however, reiterated that countries will still need to answer the fundamental questions around the problems facing infrastructure development. These include ensuring that they are not politicised to allow SWFs to do appropriate and effective project selection divorced from political lines and consider a co-investment model. This will pave way for African SWFs investing with other SWFs and African SWFs investing with development banks in which all the different parties will have different roles and different reasons for getting involved. These are very significant hurdles to clear subject to establishing a stable, sustainable and predictable medium term investment framework.

Mr. Philman observed that the co-investment model mentioned by Mr. Reitveld was already in place. The Standard Chartered Bank is the biggest private equity investor in Africa. Its investing with SWFs from around the world. Increasingly these funds - development funds - are actually set up such that the foreign SWFs can take comfort that they are co-investing.

The domestic counterpart provides better knowledge on the local environment since it was very difficult for a foreign investor to invest in sub-Saharan Africa. Investors need a lot of knowledge or expertise on the local environment and having this from the government would provide even more comfort. Furthermore, there were a lot of political risks in some of the projects and if investment is in government funds, these may be mitigated. Additionally, there is need to mobilise premium funds elsewhere as the best way of getting the most out of the domestic funds.

3.4 The Best Way to Gain Consensus on the Appropriate Balance between Current and Future Consumption

The question to Mr. Kristian Flyvholm, Secretary General, IFSWFs, was on the best way to handle and gain consensus on the appropriate balance between current and future consumption.

Mr. Flyvholm thanked MEFMI for inviting IFSWFs to attend the Forum and indicated that they had a membership of 29 SWFs based in London, met and shared experiences and encouraged countries to associate with them and become members.

Regarding the issue of consensus, he observed that countries like any other investor in the world with a fund or a government bond must have a macroeconomic objective and noted that the volatile macroeconomic situation can be made better by putting money aside in a stabilisation fund or a savings fund.

He underscored that trading-off current consumption with future consumption must involve all stakeholders. He underscored that consensus is important for charting the way forward by breaking institutional barriers. Countries should look at country case practices and learn from their experiences. This should be coordinated through the Santiago Principles - the shared principle on macroeconomic coordination. Stakeholders must come together and discuss these issues, how to achieve the objectives of such issues as stabilisation in the budget and ensuring intergeneration equity.

He pointed out that SWF should have an independent fund that would improve checks and balances, allow isolating the macroeconomic objective, which is typically long-term in nature.

A country must talk to its various local stakeholders. He indicated that IFSWFs has 15 case studies on how to set up SWFs and how they arrived on their conclusions to trade-off current and future consumption.

Honourable Christopher Mvunga, Deputy Minister, Ministry of Finance and National Planning, Zambia observed that the discussions on the issue of SWFs were impressive. However, he underscored the need to look at the practical side as most of the MEFMI member countries are not running budget surpluses. Also, infrastructure is seriously lagging behind to underpin future development and create growth opportunities including the participation of PPP. In this unique scenario, the solution needs very practical approaches. He argued that it was impossible for countries to set up SWFs when they are running budget deficits, servicing international bonds and the return on SWFs was low.

Mr. Reitveld noted that the observation is valid and countries need to start running surpluses. There is need to think about having the policies in place, if a country is a commodity producer or anticipate being one when the next boom arrive and start running surpluses. Otherwise, the return in SWFs is likely to be lower than the debt servicing cost. He underscored that the bottom line is to make sure that a country has a sustainable medium term to long-term fiscal framework.

Mr. Philman noted that with countries with huge needs for critical infrastructure, return on it is a lot higher than what they have to pay for the bonds and cited Nigeria as a good example with three (3) very clear objectives for their fund being stabilisation fund, future fund and infrastructure fund. He noted that Nigeria was injecting more money into the SWF even in the current scenario indicating their trust on the entity of SWF.

Mr. Reiveld further stated that the point is not to say that countries should not borrow, but should accumulate assets in SWFs especially if it is started gradually with a conservative portfolio. He noted that there was a sustainable and sensible amount of borrowing that African countries can do given their growth prospects which allows comfortable debt service. However, on pure financial calculation, accumulating assets in the SWFs versus servicing debt is something that needs to be considered very carefully. Similarly, the economic and social returns from good infrastructure is worth the borrowing cost but subject to having credible sustainable medium term fiscal framework otherwise countries will face high payments in the form of high interest rate costs.

Ms. Ekaterina M. Gratcheva, Lead Financial Officer, World Bank RAMP, cited the case of Botswana as particularly interesting and insightful, given that when the country started with very low levels of development, had huge needs yet within a few decades it was able to accomplish savings in accumulation of assets in SWFs as well as accomplishing impressive significant parameters.

She shared some insights from one of the policy events that the World Bank held. They invited policy makers from some of the countries that have managed SWFs and dealt with the issues of saving as well as investment in their economies including Botswana, East Timor, and Trinidad and Tobago. All the countries started from low levels of development but have been running their funds for quite some time. The common statement from the policy makers was that they all wished they had saved more. They indicated that they under estimated the capacity constraint, the ability to execute domestic investment and were overly optimistic. With the uncertainty in the market and volatility in commodity prices, they wished they had accumulated more assets that would have given them more leeway or freedom of executing their development policy rather than trying to picture how to meet the budget needs at a time when the commodity prices are collapsing.

Mr. Malik cited the cases of Malaysia and Mexico which had low surplus when they started in the 1980s and indicated that they were very sure that SWFs was a means to an end but not an answer in itself. He underscored that a country must really be clear on its medium to long-term objective economically. This must be done before embarking on the journey rather than seeing SWFs as the answer.

Mr. Kristian highlighted that Norway started looking at SWFs in 1971/72 and invested the initial amount in 1996 which means it took 25 years of consideration before they invested. He observed that countries do not have to take 25 years but they can start using the existing samples, taking the 24 Santiago Principles and trying to set up with small amounts, to see whether it can be operationalised. This should build trust and more funds can be allocated. Countries should avoid starting with large sums of money.

3.5 Thoughts on the Capacity Building Constraints in the Continent

Prof. Emmanuel Nnadozie, Executive Secretary, ACBF shared his thoughts on the capacity constraints in the continent. He pointed out that ACBF has invested in MEFMI since 1997 and made sure that it chose an approach that ensured institutional stability to conduct capacity at the executive level on a sustainable basis. He noted that MEFMI is now attracting investment from various stakeholders as a result of the support received from various financial partners including ACBF, the World Bank, AfDB and the UNDP that fund ACBF.

He observed that there was hardly any speaker who spoke without mentioning capacity gaps and constraints and therefore capacity was at the centre of the ability of countries to leverage natural resources for economic transformation.

He noted that the transformation dimension needs to be emphasised with a view to changing the structure of the African economies and transforming them into industrialisation.

He made reference to research conducted in 2013 at the UNECA on how to generate a commodity based industrialisation in the continent. He noted that the research argued that it was possible to generate a commodity based industrialisation based on the structural experience of others and the reality that the continent is faced with. This called for finding ways of ensuring value addition and getting into the high levels of international value chain and creating some strong forward, backward or horizontal linkages in the economies.

He observed that there was need to assess economies - where things are working and where they are not. He informed delegates that that ACBF in 2014 issued a report specifically on the capacity for managing natural resources which is a useful reference tool. He noted that there is need to build technical capacities to ensure that countries maximise resources for economic transformation. These should go beyond institutional capacity to include soft capacity - mind-set change, leadership and political will.

3.6 RAMP Delivery and highlights on the training

The World Bank RAMP was requested to comment on the RAMP delivery and provide highlights on the training scheduled for May 2016.

Ms. Ekaterina M. Gratcheva, stated that RAMP has been working with most of the MEFMI member countries' central banks for a long period time. She noted that RAMP has also been working with other public institutions and there is a programme that is working with central banks at all stages of development - from just thinking about setting up the funds - to countries which need help on setting up legislation and strategizing on different angles and institutional arrangements of setting up such funds - to countries that have passed legislation and need assistance to implement and institutionalise issues.

SWFs that have already been established need help to expand their capacity, broaden their investment universe and improve their governance and operations. She pointed out that public pension funds like SWFs are also an integral part of RAMP.

Regarding, the May 2016 activity, she clarified that it would be a joint MEFMI / RAMP event to be held in Kampala, Uganda and targeting on more practical implementation issues surrounding designing and implementation of SWFs. The target would be officials from MEFMI client institutions as well as other RAMP clients.

She noted that RAMP has been evolving to position itself to address emerging capacity needs of clients in SWFs from policy to implementation and is able to mobilise different teams from the World Bank Treasury and the broader World Bank Group.

3.7 Areas of Focus for MEFMI Capacity Building in the Medium Term

All the panellists were asked to indicate areas that MEFMI capacity building programmes should focus on in the medium term.

- Mr. Malik noted that Africa was at a reflection point and what is required is not incremental but a transformation approach and observed that in both public and private sector, 70% of the transformation programmes fail because of people.

  On the people dimension, countries need to be very clear on what needs to be strengthened and what needs partnering with outside organisations or outsourcing. He underscored that it was very important to note that government cannot do everything and there is need for strategic thinking on national interest and where various expertise outside government organisations are located.

- Mr. Kristian noted that he had the privilege of providing leadership to SWFs around the world, building and sharing knowledge, talking about problems and considering solutions. He observed that people are not honest about problems but once this is realised they could work and achieve a higher level of competencies.

  This can be either by resourcing talent by outsourcing; exchanging experience from others and realising what other solutions exist.

  He noted that the issue is how to continue the dialogue with MEFMI. He encouraged the Institute to associate with the Forum. He also encouraged countries to adopt the Santiago principles which he emphasised is a process. He stated that the Santiago Principles need to be put in place as a guide in country work programmes. Each year, countries can target to achieve a higher level of implementation and building the right structures with the principles as benchmarks.

- Mr. Pihlman noted that the Standard Chartered Bank had limited resources but will try to offer assistance in relevant areas. In order to truly address the issues of the infrastructure gap or the infrastructure development needs, he said countries and the ministries responsible will need to build capacity on project design and coming up with projects that can mobilise private sector funds, SWFs and public pension funds.

  He indicated that it was just very difficult to invest in Africa and policy makers really have a major role in making sure that projects are bankable and investible.

- Mr. Reitveld highlighted that Investec manages majority of largest SWFs and capacity building needs are taken very seriously. He indicated that Investec is able to offer capacity building on very micro issues such as risk management trading - through to - design of fiscal rules and governance structures.

  He concurred with the argument that one of the key areas to focus on skills development is the capacity to develop investable products that can attract owners of capital. He encouraged delegates to learn more about SWFs and to educate legislators and executive leadership on SWFs and on the appropriate roles and limitations as they are not a panacea for solving all problems.

- Prof. Nnadozie observed that it is clear that the challenge with infrastructure development is not money but twofold: First, is the **capacity for project preparation** which is different from investing in a project. He underscored that this will be of major interest and focus for ACBF going forward. In this regard, ACBF will find ways of addressing it at the country level.

  He cited the work of the Mbeki panel on illicit financial flows in which a lot of recommendations have been made and emphasized capacity on **transfer pricing or units** in countries given that South Africa is the only country with fully fledged unit even though it is not as strong as it should be. In this regard, ACBF is willing to work with anybody in this area and any other relevant area.

  He underscored that MEFMI should continue building human capacity through training programmes and other activities.

  On the significant capacity building issues of **utilisation** and **retention,** he noted that capacity is built but it is not utilised properly because of imperfections in the system that may cause failure. On capacity retention, he indicated high investments are made in human capacity development but this drains to the private sector and other forms of brain drain such as migration overseas.

  He noted that it is important that as countries build capacity, attention is given to proper utilisation and retention. Similarly he noted that parliament and legislators are critical since they play a key role in ensuring that there is accountability in implementation of projects.

4. SESSION 6: THE WORK OF THE AFREXIM BANK ACROSS AFRICA

The presenatation was made by Dr. Philip O. Kamau, Senior Director of Finance, African Import – Export Bank.

Dr. Kamau gave background information on the formation and products offered by the AFREXIM Bank across the continent and what it offers as the central bank deposit programme. He stated that in promoting inter-regional trade in African countries, main focus sectors are:

- Financial Services Sector: Working with African commercial banks;
- Energy: Oil and gas;
- Transport and Telecommunications;
- Manufacturing;
- Services;
- Agriculture; and
- Metals and Minerals.

He noted that AFREXIM Bank operates nine (9) main programmes as indicated in the table below:

AFREXIMBANK PROGRAMMES	
Line of Credit	Export and import line of credit, pre-and post-export financing and letter of credit confirmation to companies with less than US$10 million revenue. Declining in relative importance as syndications and direct financing grow.
Syndications	Participation and arrangement of syndicated loans with a maturity of up to seven (7) years.
Note Purchase	Purchase of promissory notes or similar instruments providing financing to corporates; recourse to issuer and acceptor; typically short-term.
Direct Financing	Direct lending to entities with a balance sheet of at least US$2 million and annual revenue of more than US$10 million. Pre-and post-export financing to a maximum of 80% value.
Future Flow Pre-Financing	Future-flow debt offerings that rely upon receivables not generated from export of physical goods e.g. credit cards and royalties.
Asset-Backed Lending	African content promotion in Africa's oil, gas and other mining sectors, maritime transport, railways and airline industries, and taking collateral in the form of the assets.

Project Related Financing	Limited recourse financing in support of export projects (e.g. mining, manufacturing & related projects), and infrastructure projects that facilitate exports or generate trade infrastructure services (e.g. power, ports and telecom).
Receivables Purchase/ Discounting	Purchase of specific receivables of goods and services sold to foreign or domestic buyers.
Special Risk	Guarantee of credit exposure to African borrowers against certain risk events. The programme benefits from certain exemptions and preferred creditor status of Afreximbank.

He noted that since opening business in 1994, the Bank has accrued loans amounting to US$32 billion and advanced about US$20 billion in 30 countries across the continent. He observed that as a result of the global financial crises of 2008 and 2009 and robust growth in Africa, the Bank witnessed very high demand for services and request for financing increased from about US$3 billion in 2007 to US$40 billion in 2015.

Consequently, AFREXIM Bank has developed a central bank deposit programme which is aimed at mobilising part of the foreign exchange reserves from African central banks and institutional investors to enable it meet the high level of financing needs in Africa.

This model is replicated from the success BLADEX Multilateral Bank in Latin America, which is financing trade and mobilising about US$2.5 billion annually from Latin American Central Banks. The Bank has three (3) facilities under this programme which are of interest to African central banks:

- Central Bank Time Deposit Account (TDA)

- National Export Support Account (NESA)

- Afreximbank Certificate of Deposit Account or Investment Account (AIA)

These facilities provide very attractive terms on actual deposits and the prices offered are negotiable. The benefits to participate by central banks and countries are:

- *Favourable returns* - Reserves will earn attractive returns compared to what they are currently earning elsewhere. For example for a US$50 million deposit for a period of one (1) year, AFREXIM Bank offers a return which is better by 81 basis points with comparable deposits in OECD countries.

- Unlocking of potential – Since the deposits will be ploughed back into the economy through different developmental initiatives, the economies of the participating countries will benefit from the transformation of relatively idle resources into productive resources.

- Low borrowing costs to customers in participating countries thereby increasing competitiveness.

- Leveraging national resources to fund national development.

- Liquidity support facility that will benefit respective central banks of participating countries to support trade particularly those who deposit with Afreximbank.

- In sync with the region's trade development agenda, the expansion of the Bank's support will help extend businesses and influence of participating countries to the rest of Africa via trade and other forms of investments.

Risk Management
He underscored that AFREXIM Bank has a strong risk management framework underpinning the central bank deposit programme, guided by the Risk Management Policies and Procedures (RMPP) that was approved by the Board of Directors. These call for safety of funds deposited at the AFREXIM Bank and also have a solid track record in meeting payments of debt maturities in the markets.

For example in the last six years:

- AFREXIM Bank borrowed a total of US$8.238 billion between 2008 and 2014;

- Retired/repaid US$4.383 billion to the lenders; and

- AFREXIM Bank has never defaulted since commencement of business. Even during the 2007-8/9 global financial crisis; the Bank honoured its obligations without difficulty.

Treasury Controls and Liquidity Management and other measures

- AFREXIM Bank has a robust treasury control with clear segregation of duties and internal controls Risk Department and Internal Audit compliment with an independent checking and control oversight to manage deposits that the Bank takes.

- Conservative liquidity management philosophy which is Basel III compliant. By 30th June 2015, the liquidity recovery ratio was 600%.

- The bank has financial strength with capital funds of about US$1.1 billion as at 30th June 2015 and has been profitable since it started business in 1993.

- In 2014, net income grew by 18% from US$89 million in 2013 to US$105 million in 2014, with a loan volume of about US$4.4 billion and total asset base of US$6 billion.

- The Bank also has a very strong loan quality with a non-performing loan ratio of 1.27% as at 30th June 2015.

- Capital Adequacy Ratio is also very strong at 26%.

- Callable capital is $423.2million, which can be tapped in case of need.

Credit Rating
The Bank has investment grade rating by major internationally recognized rating agencies of:

- *AA by Association of African Development Institutions (AADFI);*
- *AA+ by AGUSTO;*
- BBB- By Fitch; and
- Baa2 *By Moody's*.

Dr. Kamau concluded his speech by inviting delegates to seek recourse on their facilities.

5. STATEMENT BY EY

Mr. Joe Cosma, EY Partner gave a statement in which he expressed his company's appreciation for the partnership with MEFMI particularly for the Combined Forum.

He stated that EY strongly believes that collaboration between the private sector and the public sector and through such fora as the Combined Forum, the region will be able to achieve its objectives. This will also allow the region to meet some of the challenges that bedevil Africa, especially sub-Saharan Africa. He underscored that Sub-Saharan Africa has great potential even though it is going through a difficult time. Countries leverage on each other's strengths and can collaborative with the private sector and the donor community.

6. VOTE OF THANKS AND CLOSURE BY HONOURABLE JOSÉ PEDRO DE MORAIS, GOVERNOR BANCO NACIONAL DE ANGOLA AND CHAIR, MEFMI BOARD OF GOVERNORS

Governor De Morais gave the vote of thanks in which he expressed his sincere appreciation to all delegates who participated at the 2015 Combined Forum. He noted that the event had indeed become one of the must-attend high value events on the calendar of activities for the MEFMI region. He thanked all the presenters and panelists and underscored that the intellectual input will contribute immensely in shaping the policy landscape in the region. He commended the speakers for exceeding expectations as they provided interesting and relevant insights on the theme which has critical policy relevance to the region.

He also directed his commendations to the most important players in this Forum, namely the distinguished participants who made the event a success through lively input from the floor. He expressed hope that the region will continue building on the partnerships and collaborations developed.

He also thanked the MEFMI Secretariat and the various partners who worked behind the scenes to facilitate the arrangements. He commended MEFMI for bringing delegates together to the auspicious occasion to tackle a subject that is very close to delegates‘ hearts. He noted that the Combined Forum provides a rare opportunity for policy makers to exchange ideas with eminent experts who provide global experience.

He stated that the report on the proceedings of the event should be used by all delegates as a reference document.

He expressed gratitude to the host country, the Government and the people of Peru.

7. COCKTAIL AND BOOK LAUNCH

The event closed with a cocktail that was hosted by Investec. Held back-to-back with the cocktail was a MEFMI book launch. The books were unveiled by Governor Charles Chuka of the Reserve Bank of Malawi.

In his address during the book launch, Dr. Fundanga pointed out that MEFMI capacity building interventions are delivered through various modes and that studies and publications are some of the critical methodologies that the Institute employs. He pointed out that the Secretariat had taken advantage of the 2015 Combined Forum to launch the world class publications on:

i "Assessing Gains from Natural Resources in the MEFMI Region: Focusing on Foreign Direct Investment (1995-2013)

This is a pioneer study that was conducted by MEFMI in the area of Natural Resources Management, which the Institute has recognised as critical area for capacity intervention. He highlighted that the study is a theoretical and empirical assessment of the gains from natural resources with an emphasis on Foreign Direct Investment. It provides policy lessons and recommendations that can be considered by member states as they explore alternative policies in natural resources management.

ii "The Enumerators' Handbook on Conducting Foreign Private Capital Surveys"

Similarly, he pointed out that the Handbook provides enumerators with a structured step-by-step approach on the collection and administration of private capital flows' questionnaire. The Handbook is customized to address the realities of data collection in the region and is benchmarked to international standards governing external sector statistics. He expressed optimism that this handbook will help in harmonizing survey methodologies across the MEFMI region.

He pointed out that as the Secretariat publishes more studies, technical staff in member states will find the publications to be useful references as they deliver on their mandates.

He thanked MEFMI staff and Fellows who conducted the studies, and officials from client institutions and technical cooperating partners who provided reviews that contributed to the successful delivery of the two (2) publications.

He further underscored that as most of the officials support the ethos of research and publishing, he emplored delegates to encourage their staff and in particular, MEFMI Fellows, to add to the body of knowledge by contributing to its publications such as the MEFMI Forum and to actively participate in MEFMI led research studies.

He cited Bill Gates' words that ***"Governments will always play a huge part in solving big problems. They set public policy and are uniquely able to provide the resources to make sure solutions reach everyone who needs them. They also fund basic research, which is a crucial component of the innovation that improves life for everyone."***

8. MEFMI COMBINED FORUM PROGRAMME

COMBINED FORUM FOR MINISTERS OF FINANCE AND/OR OF PLANNING, SECRETARIES OF FINANCE AND/OR OF PLANNING AND CENTRAL BANK GOVERNORS

TUESDAY 6TH OCTOBER 2015

INDEPENDENCIA NORTE SUR, SHERATON LIMA HOTEL AND CONVENTIONAL CENTRE, LIMA, PERU

Theme: "Leveraging Natural Resources for Economic Transformation"

Time	*Event*	*Speaker/Presenter*	*Moderator*
OPENING 09.00 – 09.30 hours	*Welcome Remarks*	**Dr. Caleb M. Fundanga,** MEFMI Executive Director.	
	Official Opening	**Senator Martin Dlamini,** Minister of Finance, Swaziland	
1st SESSION 09.30 – 09.40 hours	*Role of Leadership in the Management of Natural Resource Revenues in Africa*	**Ms. Arunma Oteh,** Treasurer and Vice President, World Bank	Honourable Patrick Chinamasa, MP, Minister of Finance, Zimbabwe.
09.40 – 10.30 hours	*Natural Resource Wealth Management: Highlights from the 2015 Governors' Forum*	**Dr. Caleb M. Fundanga,** MEFMI	
10.30 – 10.45 hours	**TEA/COFFEE BREAK AND GROUP PHOTOGRAPH**		
2nd SESSION 10.45 – 11.45 hours	*Transforming Depleting Natural Resources into Income for Growth*	**Mr. Bernard Murira,** World Bank Treasury, RAMP	Hon. Claver Gatete, Minister of Finance and Economic Planning, Rwanda
3RD SESSION 11.45 – 12.45 hours	*Taxation of Natural Resources: Principles and Policy Issues*	**Mr. Charles S. Makola,** Partner-International Tax & Tax Policy, Africa, EY	Dr. Kamau Thugge Principal Secretary, The National Treasury, Kenya
12.45 – 14.00 hours	**Remarks by EY and Investec Asset Management, LUNCH**		
4TH SESSION 14.00 – 15.00 hours	*Sovereign Wealth Fund Management: The Case of Botswana*	**Ms Linah K. Mohohlo,** Governor, Bank of Botswana	Prof. Benno Ndulu, Governor, Bank of Tanzania
5th SESSION 15:00 – 15:45 hours	*Managing Africa's Revenues: In search of stability and Diversification*	**Mr. Malan Rietveld,** Investec Investment Institute	Mr. Jean Ciza, Governor, Banque de la République du Burundi

Time	*Event*	*Speaker/Presenter*	*Moderator*
5TH SESSION **15.45 – 16.55 hours**	*Panel Discussion: Lessons and Way Forward*	Participants: **Ms. Ekaterina Gratcheva,** World Bank Treasury, RAMP; **Mr. Rohan Malik,** Partner: Emerging Markets Leader & Deputy Global Government & Public Sector leader, EY; **Mr. Malan Rietveld,** Investec; **Mr. Kristian Flyvholm,** Secretary General, International Forum of Sovereign Wealth Funds (IFSWFs); **Prof. Emanuel Nnadozie,** Executive Secretary, African Capacity Building Foundation (ACBF)	Mr. Patrick Mutimba, MEFMI Director, Financial Sector Management Programme
6TH SESSION **16.55 – 17.00 hours**	*The Work Afrexim Bank is Doing Across Africa*	**Dr. Philip O. Kamau,** Senior Director of Finance, African Import – Export Bank.	
17.00 -17.02 hours	*Closing Statement By EY*	**Mr. Joe Cosma,** Government & Infrastructure Sector Leader	
1702 – 17.10 hours	*Closing Statement By MEFMI*	**Dr. Fundanga**	
1710 – 17.45 hours	*Vote of Thanks and Closure*	**Mr. Jose Pedro de Morais,** Governor Banco Nacional de Angola and Chair, Board of Governors.	
18.00 – 20.00 hours	**BOOK LAUNCH AND COCKTAIL**		

Director of Ceremonies: Mr. Raphael Otieno, MEFMI Director, Debt Management Programme

MEFMI — Macroeconomic and Financial Management Institute of Eastern and Southern Africa

EY

Investec Asset Management

MEFMI BOOK LAUNCH
6th October, 2015
SHERATON LIMA HOTEL AND CONVENTIONAL CENTRE
LIMA, PERU.

17:45	Arrival of Guests
18:00 - 18:30	Welcome Remarks and Overview on the 2 Books: MEFMI Executive Director – Dr. Caleb M. Fundanga **1. Assessing Gains from Natural Resources in the MEFMI Region: Focusing on Foreign Direct Investment (1995-2013)** **2. The Enumerators' Handbook on Conducting Foreign Private Capital Surveys**
18.10 – 20:00	Cocktail

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Institute of Eastern and Southern Africa

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