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What Role for Sovereign Wealth Funds in Africa's Development?

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Abstract

The discovery of natural resources in a developing country is not generally the good news it appears to be. In fact, resource-rich developing countries face the significant challenge of using their natural wealth to improve the living standards of average citizens, rather than wasting it through weak institutions and corruption – a phenomenon often referred to as the "resource curse." Civil wars and political turmoil tend to exacerbate the problem. One increasingly popular option for dealing with the resource curse is the commodity-based sovereign wealth fund (SWF). Angola, Ghana, Mozambique, South Africa, Uganda and Nigeria are set to join other African countries, such as Botswana and Mauritania, in turning to these special-purpose financial vehicles to help ensure proper management of resource revenues. By sequestering some of their resource revenues in a SWF, these countries hope to smooth resource price volatility, make long-term fiscal policy, manage currency appreciation, facilitate intergenerational savings, and, perhaps most importantly, minimize corruption and tame the political temptation to misuse the newfound wealth. However, as Nigeria's experience with the Excess Crude Account illustrates, it is not enough just to set money aside. The success of SWFs is ultimately a function of good governance and clear mandates. This paper illustrates the key ingredients required for an SWF to succeed at facilitating development in the African context.

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Bios

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Preface

The discovery of oil in a developing country is potentially beneficial and, simultaneously, potentially calamitous. While this so-called resource curse is well established in the literature, solutions to counteract its corrosive effects remain highly elusive. CGD's Oil-to-Cash initiative is exploring one policy option that may address the root mechanism of the resource curse: using cash transfers to hand the money directly to citizens and thereby protect the social contract between the government and its people. Under this proposal, a government would transfer some or all of the revenue from natural resource extraction to citizens in universal, transparent, and regular payments. The state would treat these payments as normal income and tax it accordingly—thus forcing the state to collect taxes, fostering public accountability and more responsible resource management.

This background paper by Ashby Monk and Adam Dixon, commissioned as part of CGD's Oil-to-Cash initiative, explores the role of Sovereign Wealth Funds (SWFs) as a mechanism to help resource rich countries manage revenue flows. The authors argue that the success of such funds is a function of good governance and a clear mandate, both of which are particularly challenging in low-income African countries discovering oil. The difficulty in protecting even the best-intentioned funds from falling prey to political pressures suggest that establishing a SWF is just one small step toward sound resource management in Africa.

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1) INTRODUCTION

In the coming decade, Africa will become the largest sponsor of sovereign wealth funds (SWFs) on the planet. How is this possible? Estimates vary, but the number of funds in Africa that currently fit within the International Monetary Fund's (2008) typology of SWFs range from the low- to mid-teens, with sponsors from Algeria and Botswana to São Tomé & Príncipe and Sudan. Add to that the number of countries considering or constructing new SWFs, such Angola, Ghana, Mauritius, Mozambique, Nigeria, Rwanda, South Africa, and Zimbabwe, and it is relatively easy to see how Africa could soon be home to upwards of 20 or more SWFs. Ironically, this would place the greatest number of sovereign *wealth* funds on the *poorest* continent in the world. And this raises an important question: Why is such an impoverished region so enamored with SWFs?

African countries see in SWFs a potentially powerful tool for managing resource revenues. For many African countries, discovering natural resources has not been the good news it appeared to be. In fact, academic research shows that these resource rich countries have experienced lackluster growth, notwithstanding intermittently high growth during commodity price booms (Auty 2001; Karl 1997; van der Ploeg 2008). Industrial and agricultural production is generally weak and inefficient to the extent they exist; and, extractive industries have crowded-out investment in other sectors, limiting job creation elsewhere. Resource abundance has also been associated with civil wars, particularly in sub-Saharan Africa (Frankel 2010; Ross 1999; Rosser 2006).

Recent research explains this 'paradox of plenty' as a function of institutional quality (Mehlum et al. 2006); the countries with well-governed and designed institutions are more likely to use their resources to improve economic and social outcomes than those with weak and poorly designed institutions. In fact, the IMF recently argued that if Sub-Saharan countries improved the quality of their institutions to that of developing Asia, it would result in a "near doubling" of the region's per capita GDP (International Monetary Fund 2010). As such, there has been a renewed focus among policymakers on upgrading and innovating the institutional toolkit for resource rich countries. In particular, there has been a focus on institutions that can help smooth resource revenue volatility, support sustainable government spending, manage currency appreciation, minimize political temptation for malfeasance, and even facilitate inter-generational wealth transfers, among other things (see Bagattini 2011 for review). It is in this respect that SWFs have come to play an important role.

SWFs exist, at the most basic level, to underwrite and sustainably improve living standards within sponsoring countries (Gould 2010). And the mechanism through which SWFs achieve these lofty objectives is finance. At its core, a commodity-based SWF converts sub-soil assets into financial assets, which means that SWFs are, ultimately, just a point for governments to access the power of global finance. Why is this useful for sponsors? It turns out the financial capital, and the investment returns SWFs generate, affords the sponsors added flexibility to achieve downstream policy objectives subject to risk and uncertainty. For example, a SWF can help to stabilize the macro-economy by keeping some assets offshore. It can smooth resource revenues to make budget allocations more predictable. And, it can offer countercyclical resources for the economy following an economic shock. Moreover, as a storehouse of financial assets, SWFs can help maintain a balance between current expectations and long-term commitments. Through all of these functions, SWFs are capable of dampening or, at the very least, managing the negative consequences of resource wealth.

As this suggests, for a SWF to achieve its objectives, it has to be effective at asset management. This, however, is not a simple feat, as countries set up new SWFs precisely because the functions that these institutions perform are not easily integrated into existing government agencies. Indeed, the complexity and sophistication of financial management necessitates an innovative approach beyond the traditional government apparatus. In this regard, the SWF is a purpose built institution, designed specifically to operate in financial markets. It will thus have distinctive characteristics that separate it from government agencies and departments, and these differences are what make SWFs (in theory) able to compete against the private sector investors that populate global financial markets. In a manner of speaking, then, a SWF is a 'special purpose vehicle' because it has a truly special purpose: to successfully invest government assets in global financial markets.

Notwithstanding their benefits (and their recent popularity), SWFs are not a universal remedy for the problems facing resource rich countries. In fact, the SWF "solution" to the complicated problem of resource management is extremely complicated in its own right. Governing, managing and operating a SWF can be inordinately challenging, as these are organizations modeled on high-performance Western institutional investors (Clark and Monk 2012). So, for an SWF sponsor to realize the benefits of such a fund, the establishment of a SWF must be part of a broader package of institutional reforms designed to improve the country's capacity for resource revenue management. In short, the creation of a SWF will not, on its own, improve fiscal and monetary outcomes (Davis et al. 2003). These funds are not a replacement for broader institutional development and poverty alleviation (Rodrik 2005). A SWF does not, for instance, replace the need to foster and stimulate a capable and active workforce; nor does a SWF replace effective regulations and the rule of law. It is simply a new(ish) tool in the resource revenue management toolkit.

In the right circumstances, though, a SWF can be a useful addition to a country's toolkit for combating the resource curse. But to increase the likelihood of success, these funds have to be designed with intent to deliver on promised results. In our experience, this requires good governance principles and practices. As such, the real challenge for resource-rich African countries is designing, governing and managing a SWF that can realistically achieve the objectives set out for it by the government. In this regard, a particular set of governance principles needs to be met, and governments should only wield these funds in the right circumstances. In this paper, we provide insights into the governance practices and the circumstances that will maximize the likelihood that governments using SWFs will achieve their objectives.

2) A NEW HOPE

SWFs are special purpose vehicles that invest state assets in financial markets in order to manage some macro-economic or fiscal issue. At the most basic level, these funds exist to underwrite and sustainably improve living standards within sponsoring countries, as the funds' assets and their accumulated returns can be invaluable for managing a variety of intractable problems. While an SWF typology developed by the IMF has five sub-types (2008), three are particularly relevant for developing countries in Africa: stabilization funds, development funds, and saving funds.[1] In this section, we highlight the utility and benefits of each sub-type to their sponsors. In subsequent sections, we illustrate the challenges and pitfalls associated with these same funds.

A) 'Stabilization Fund': Some SWFs exist to insulate resource dependent economies against commodity price swings. Knowing that commodity prices can be highly volatile – witness the dramatic collapse of crude prices in 2008 – a stabilization fund helps to smooth commodity price volatility by setting clear rules for the deposit of a portion of revenue during periods of high commodity prices so that the government has a stable source of income, following clear withdrawal rules, during periods of low commodity prices (Collier et al. 2009). Chile is considered to have the most sophisticated deposit and withdrawal framework (see Frankel 2011). Ultimately, such stability is important, as it helps stretch the government's planning and investment time horizon.

In addition, stabilization funds can function as a lender of last resort that buffers the economy from a variety of macroeconomic shocks (e.g., a local banking crisis or an international balance-of-payments crisis). One reason many countries arguably maintain a SWF is to limit their reliance on external help in the event of a shock, since such external intervention comes with conditionalities that may be overly harsh, potentially unsuitable for local conditions, and politically undesirable. For instance, the buildup of foreign-exchange reserves and budget surpluses in East Asian countries, and the subsequent establishment of SWFs, is arguably a form of self-insurance against external policy coercion. Indeed, IMF structural adjustment policies following the Asian financial crisis of 1997 were not openly welcomed in some countries. Given the buildup of reserves, East Asian countries are now conceivably capable of mitigating crises without external help. As such, they avoid external interference (Griffith-Jones and Ocampo 2008).

In terms of investment policies, stabilization funds are short-term oriented and risk intolerant. They hold a variety of liquid assets that can be quickly mobilized should the government have a need for them. The assets are also often held overseas to minimize currency appreciation and to help manage the economies' absorptive capacity.

B) 'Development Fund': If established as a separate entity and operated by professional investment managers that are relatively insulated from partisan politics, a development fund can help facilitate growth in the local economy. Indeed, according to the IMF (2008), a development fund can make investments that support, if implicitly, wider socio-economic projects and industrial development that help raise a country's potential output. The development fund complements direct investment through the state budget allocation process (or through a local development agency), which is not

[1] The other two types of funds considered by the IMF are reserve investment corporations and contingent pension reserve funds.

driven by specific financial return objectives but explicitly seeks large externalities. As such, the development fund does not target externalities per se, but, through commercially oriented investments, it may produce beneficial externalities.

Abu Dhabi's Mubadala, Bahrain's Mumtalakat, Kazakhstan's Samruk-Kazyna, Malaysia's Khazana, and Singapore's Temasek are examples of such funds. The sponsoring government, to which these funds are accountable, provides these SWFs with a mandate and initial capitalization, but they are left to generate commercially viable opportunities independent of the government budgetary process. In contrast to direct government spending, these funds operate like a private equity fund, making investments on a purely commercial risk-return basis compared against competing opportunities elsewhere. As such, the investment managers may be more apt at picking winners so-to-speak, instead of the white elephants that may be more likely to happen in a politicized budget allocation process.

For example, if most investors are loath to invest in untried and underdeveloped markets, the development fund can, in theory, help crowd-in investment from both local and international sources. By supporting financial market development and market liquidity locally, which may coincide with strategic firm alliances made internationally, the SWF may help improve the investment climate over time. If employed in this manner, SWF investments can be a source of discipline for local firms, driving them to perform to global standards of competitiveness. In this context, a development fund may contribute to the productive efficiency and diversification of the economy. This is important for the country's economic development, as experience shows that a shift from primary commodity production to industrial and services production generally coincides with higher growth rates (Maddison 2001).

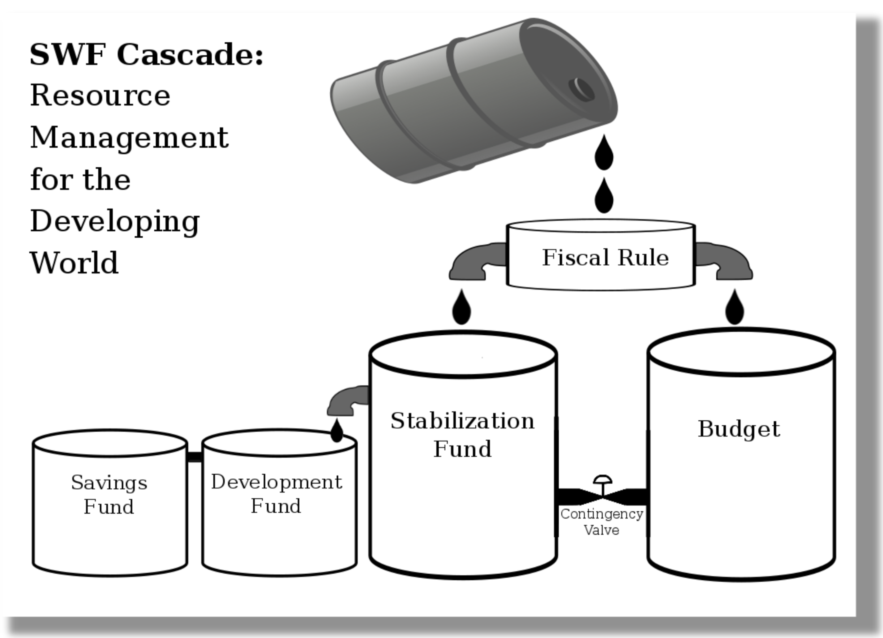
However, employing a SWF in this fashion clearly comes with some caveats and risks. When developing local markets, there is a higher chance that investments will be made for political reasons that ultimately risk undermining the long-term health of the SWF, particularly if such investments are made in underperforming firms or industries. As such, making markets locally through a SWF must follow strictly defined investment decision-making standards set by a democratically accountable body to ensure risk-adjusted rates of return compare favorably with competing opportunities elsewhere. In a similar vein, making strategic acquisitions abroad requires a rigorous framework that prevents vanity or trophy investing, which will erode returns (and limit the fund's effectiveness at combating the resource curse). Moreover, taking strategic positions in foreign companies can also heighten potential political confrontation with the receiving country (Monk 2009). However, international policy dialogue and the creation of the Santiago Principles is helping develop best-practice governance standards and transparency frameworks for SWFs to follow with the intent of limiting political confrontation (see Truman 2010).

C) 'Saving Fund': A SWF can also be used to support intergenerational equity (Solow 1986). Indeed, saving funds exist to share current wealth with future generations, siphoning off present revenues for future consumption. In a developed country context, these saving funds are widespread and effective; they are a useful tool for countries to limit the impacts of Dutch Dise ase and they are a useful commitment mechanism in that they discipline short-term political spending. Developing countries, however, must weigh the benefits of domestic investments against the benefits of an international saving fund.

In terms of investments, saving funds have an inter-generational time horizon (at least in theory) and are able to bear considerable risk (especially compared to their shorter-term cousins, the stabilization funds). Saving funds will thus hold a variety of risky and illiquid asset classes, including private equity, real estate and infrastructure, generally in foreign markets.

These three types of SWFs – stabilization, development, and saving – are potentially powerful tools for developing countries to manage their resource revenues. To be sure, the specific circumstances of each country will determine which type(s) of funds are set up and at what time. Moreover, it is conceivable that these funds will evolve as conditions evolve and local capacity and expertise improves. In Russia, for example, the stabilization fund established in 2004 evolved to include a stabilization fund and a saving fund in 2008. In Bahrain, the existing development fund is today evolving into a saving fund. In short, the form and function of the SWF must take into consideration the local circumstances in order to ensure success over the long term.

3) SWFS IN AFRICA: A POLICY FRAMEWORK



For developing and frontier economies with resource wealth, we propose a simple policy framework for deploying SWFs: the 'SWF Cascade'. We think resource rich African countries can benefit from setting up three separate SWFs *over time*: 1) a stabilization fund; 2) a development fund; and, lastly, 3) a saving fund. As the graphic above suggests, the SWF cascade funnels a country's commodity wealth through a fiscal rule. Most of the wealth will likely go into the state budget, but some will also be funneled into different types of commodity funds on a staggered basis. The rationale for the stagger stems from the different concerns facing developing economies compared with fully mature developed economies. Indeed, while a long-term savings fund to prevent Dutch Disease and facilitate intergenerational equity may be appropriate for Norway, it is probably <u>not</u> appropriate for a capital starved, developing economy in Africa. We explain why below.

The first type of SWF African countries should deploy is a stabilization fund. Research shows us that commodity price volatility is the most damaging factor for developing economies and is the most important factor in the resource curse (van der Ploeg and Poelhekke 2009). A stabilization fund will immediately minimize volatility by smoothing resource revenues. The fund will hold a highly liquid portfolio of assets, which the sovereign sponsor can then use to manage short-term exchange rate fluctuations and, should it become needed, be employed as a lender-of-last-resort. Its sole function, then, is economic stabilization. Once the stabilization fund has sufficient reserves to ensure stability, the developing country can then deploy a development fund.

If a country wants to grow, it has to invest. As conceived, a stabilization fund is inappropriate for such a task. Domestic investments (outside of the government budgeting process) should be the domain of a separate development fund with a purpose-built design and governance structure. We think of development funds as 'holding funds' because their early existence is about holding assets offshore until such a time as domestic investments become commercially viable. Due to constraints in absorptive capacity, finding viable investment opportunities at the local level can be quite challenging. As such, a development fund holds assets overseas until such a time as commercially viable opportunities arise domestically. In this respect, it should not contribute to inflationary pressures or Dutch Disease. After all, if a domestic project has an expected return of 10%, but domestic inflation is 9%, the project will not make sense in real investment returns and the SWF will continue to hold its assets offshore. Unlike budgetary spending, a holding fund that maintains strict commercial orientations should be able to weigh competing investments overseas and in the local economy. Over time, the 'holding fund' will evolve to something more like a traditional 'holding company' in that it will hold a variety of commercial stakes in the country's domestic industry.

Finally, after the stabilization and development funds have reached target levels, a developing economy may then want to consider an inter-generational saving fund. In our view, the savings fund is the final step in the SWF Cascade and, in the ideal, its creation is symbolic of a country's maturing economy. Indeed, we think it impractical for a capital starved, developing economy to save its commodity revenues in long-term assets overseas. For a developing country, we would prefer to see those investments in the domestic economy (via a 'holding fund'). We are circumspect about the benefits of a saving fund in the developing country context; these funds are really for capital abundant economies in the developing world.

4) SWF INGREDIENTS FOR SUCCESS

Thus far, we have tried to highlight the positive benefits resource-rich countries may obtain from SWFs. However, we are not naïve as to the prevailing political and institutional conditions that continue to exacerbate economic and social development across Africa. As Nigeria's experience with the Excess Crude Account illustrates (see Box 1 in Appendix), it is not enough just to set money aside in a special purpose vehicle. Getting the structure and internal operations of a fund right takes concerted effort and commitment on the part of the sponsor and the fund's designers. The following ingredients are crucial to a SWFs success:

1) Symmetry of Intent: For the SWF 'solution' to work, it must be part of a wider institutional reform effort – one that creates an environment where the sponsor and other stakeholders (the public) believe in the long-term mission and success of the fund. Indeed, the first test for whether a SWF is a viable policy option for a developing country is to evaluate the symmetry of intent between the government and the fund. By government we mean the legislative body through which policy decisions are deliberated and the executive apparatus through which policies are employed. Ultimately, what the government wants to do, what the government can do, and what the SWF is set up to do all have to be aligned if the fund is going to meet its objectives. This may seem a rather simple condition, but there are numerous sovereign funds that have failed because the government's intentions were misaligned with the SWF's. Recall that the pool of assets in the SWF is there to manage a specific macroeconomic or fiscal problem, which means that they need to be invested in a specific way in order to meet its objectives. If a sponsoring government injects itself into the investment decision-making process of its SWF for short-term political benefit, redirecting the assets of the fund, then the symmetry of intent is broken and the likelihood of SWF failure increases. Indeed, if symmetry of intent is lacking, no design or governance trick will prevent a SWF from falling victim to political or bureaucratic encroachment. If this symmetry exists, however, a properly designed and governed fund can be extremely useful.

2) Contingent Design: A successful SWF design is one that recognizes a fund and sponsor's limitations (as opposed to their strengths). Such limitations can come from the size of the fund, the expertise of its managers, or the speed at which it can change asset allocations. The fund's limitations are also likely to come from the immediate institutional and political environment surrounding it. As a result, the sophistication of the fund and its operations should be reflected in the general sophistication of the immediate institutional environment. Said slightly differently, achieving sophistication in asset management takes considerable time and resources. Most SWFs from developing countries would find it difficult and costly to buy-in expertise from abroad, let alone find the sufficient expertise at home necessary to operate a sophisticated and diverse investment strategy, particularly strategies related to strategic investment. For many sponsors, then, a simple investment strategy aimed at achieving at least benchmark returns is the most prudent choice in the first instance. And, once more for good measure, the mission of the fund (e.g., stabilization or dividend transfers) must match the investment strategy.

3) External Advisors: The IMF, the World Bank, and other development agencies are important for relaying global practices to the local SWF designers. Such advisers can be crucial in providing technical support in deciding what type(s) of SWF should be established in relation to broader policy objectives (e.g., macroeconomic management; poverty alleviation) and in relation to the broader institutional capacity of the sponsoring government. External advisers can help local designers to isolate specific objectives and relate them to purpose-built organizational solutions. Moreover, external advisers can be helpful in broader terms of helping governments develop an institutional and economic policymaking climate that supports indirectly SWF development and long-term wealth management. However, the external advice should not be about providing "blueprint models" of a SWF. Each SWF should be different, reflecting local inputs and conditions. And the local designers are best placed to understand these local circumstances. External advisors should see their role as one of helping local designers think through how they can overcome local constraints while achieving "best principles" for SWF asset management. SWFs are long-term institutions that are ultimately a local endeavor; external support is at best short term.

4) Good Governance: One would hope that a SWF could be set up such that it is insulated from instability just as one would hope that the fund could help underwrite political and economic stability. But it is important to reinforce that establishing a SWF and sustaining its capacity over the long term confronts the same problems already constraining economic growth and development. The prevailing institutional and political reality cannot be ignored. For example, political elites and interest groups may try to use the fund for their own gain or clientelistic activities. For resource-rich African countries, the scope of challenges in this regard is wide. Such prevailing conditions may even constrain the establishment of a SWF not to mention the employment of the fund for development goals. For example, the ruling elite may find it useful to establish a SWF, but only as a means of maintaining its power or financing pet projects (see Box 1 in Appendix) (Dixon and Monk 2011). Likewise, if partisan politics is divisive and unstable, the SWF may not survive a change in power. So, establishing a SWF and ensuring it operates to support broader social and economic development objectives is easier said than done. Whereas best-practice corporate governance principles can mitigate principle-agent problems, broader political and institutional development is still necessary to foster an environment whereby the sponsor itself is monitored. As such, a more expansive checklist for governance practices is necessary for SWFs operating in the developing world.

5) THE SWF GOVERNANCE CHECKLIST

For a SWF to achieve its objectives in Africa, it will require rigorous and innovative governance practices. The following list offers a useful checklist for any SWF designer; Clark and Monk (2011) refer to these as the Three Ps:

- **<u>People</u>**: The success of a sovereign fund is conditioned by the quality of its human capital; the people that manage the money within the fund are its most valuable asset. In order to ensure SWFs have the people they need, governments should focus on the following practices:

  - *Leadership*: The fund must seek out a highly qualified and respected board of directors and management that offers <u>outward credibility</u> and <u>inward discipline</u>.

  - *Talent*: Priority should be given to attracting, incentivizing and retaining highly competent investment professionals, Which means that all hiring decisions should be based exclusively on an individual's financial competency (and not their connections or relations).

  - *Resourcing*: Each element in the investment process should be allocated appropriate resources (financial and time) consistent with its potential impact on investment performance. And those individuals that understand the requirements of the task at hand should make the resourcing decisions; the uninitiated may not understand the technological or human capital required for success.

  - *Alignment*: Performance must drive compensation, but the fund should smooth the performance related pay to align the interests of the individual portfolio managers with those of the institution over the long term. The objective here is to link the reward system to the SWF's mission – to create a shared responsibility for performance vis-à-vis objectives.

- **<u>Process</u>**: The investment decision-making process is an important value generator for any financial institution; it is crucial for the success of a SWF. The following practices are paramount in this regard:

  - *Mission Clarity*: Sponsors must develop a set of well-articulated investment goals and objectives. Specifically, the founding legislation should define the <u>*economic*</u> welfare of the fund as its pre-eminent (if not singular) focus. Put another way, political and social investment objectives (that tend to negatively impact returns) should be formally rejected.

  - *Accountability*: Formal mechanisms are needed through which the fund reports to its sponsor and related stakeholders. These mechanisms should be based upon the institution's overarching purpose and mandate, and underwritten by appropriate levels of transparency (reports, statements of transactions, etc).

  - *Investment Beliefs*: An explicit statement of core 'investment beliefs' is needed that ultimately guide investment decision-making. These are beliefs about the way financial institutions and market agents behave. Investments should also reference a 'risk budget' that aligns investment goals with the institutional risk profile. And investment strategies must be aware of the fund's limitations and constraints.

- *Dynamism*: Innovation and learning should be deliberately encouraged, and funds should be capable of responsive decision-making. This should be on a real-time basis rather than a calendar-time basis.

- *Communications*: Engaging with the domestic population is tantamount to ensuring the fund's legitimacy over time. Public support allows the fund to maintain a long-term investment horizon and limits the possibility that the fund will be forced to sell assets at a discount because stakeholders change their minds about a particular investment strategy.

➢ **Politics**: The portfolio managers within a sovereign fund must be free of external influence to achieve investment returns. Moreover, while these funds are government sponsored, the government should refrain from interfering in the actual investment decision-making. In order to ensure this takes place, the following practices will be important:

- *Legitimacy*: It is imperative that the funds maintain popular appeal such that the domestic population grants latitude to invest over the long-term (including a recognition that the fund may have loss making years as part of a long-term focus). Demonstrating functional efficacy and performance, while basing the operations of the fund on objectives that have popular appeal in the community, helps underwrite popular legitimacy.

- *Mandate*: The fund's founding legislation must provide clear guidelines as to how the overarching purpose of the organization shall be met. This should include, where relevant, suitable limits and constraints on risk and resources.

- *Authorities*: The rights and responsibilities of the sponsoring authority should be clearly articulated. In addition, the rights and responsibilities of the fund's governing board should be clearly articulated.

- *Withdrawals*: Any and all future financial obligations (contingent or otherwise) should be identified and integrated into the mandate such that withdrawal procedures are clearly articulated and defined.

- *Board Appointments*: SWFs should have a rigorous process for board nominations that ensure members appointed to the institution have expertise and are free of political agendas. This can be based on a set of a priori expectations regarding candidates' expertise and experience.

- *Boundaries*: There must be a clear demarcation of responsibility between the sponsor, the board and the fund's management. Accordingly, roles and responsibilities should be defined in detail, and the rights of stakeholders to demand action from another stakeholder must be explicitly detailed a priori.

- *Code of Conduct*: All employees, board members and stakeholders must pledge to abide by a strict code of conduct governing permissible behavior that includes being a whistleblower where others breach the Code.

- *Force Majeure*: If exceptions to a stakeholder's roles and responsibilities cannot be reasonably identified at the time when the institution is established, the process whereby exceptions would be invoked should be foreshadowed if not in legislation then at least in the rules governing the relationship between the sponsor and the institution.

The extent to which a sponsor will be able to integrate all of the above principles and practices will depend largely on the specific circumstances of the sponsor. In certain cases, it will be next to impossible to achieve all of the above, which means the designers will have to be mindful of these limitations. However, a fund that can incorporate all of these principles and practices into its design and governance will dramatically increase its capacity for success.

6) CONCLUSIONS

You'd be forgiven for experiencing cognitive dissonance at being told that Africa, the poorest continent, may soon be home to the most sovereign wealth funds in the world. But for the resource rich countries of Africa, these institutions represent a new hope for resolving the 'paradox of plenty'. By sequestering some of their resource revenues in a SWF, these countries seek to smooth resource price volatility, make long-term fiscal policy, manage currency appreciation, facilitate intergenerational savings, and, if structured appropriately, minimize corruption and tame the political temptation to misuse the newfound wealth. While, these special-purpose vehicles are not a replacement for spending through the budget allocation process, they represent an innovative attempt to leverage a country's natural resources. Indeed, the intention is to use resources to facilitate, instead of constrain, growth and development (see Box 2 in Appendix).

Notwithstanding the potential benefits, however, SWFs are really just a point of access for governments to tap into the power of financial markets. The rationale underpinning their existence is that SWFs' financial assets and accumulated returns will afford the sponsoring government considerable utility in managing certain fiscal and monetary problems downstream. While that may be true, it demands that these countries build first-rate institutional investors capable of managing money on a global scale. As such, whatever the form of SWF chosen – stabilization, development, or saving – the objectives must be clear and the sovereign sponsor must demonstrate a credible commitment to the stated investment mandate. Without symmetry of intent, strong design, good advice, and robust governance, the fund will struggle to meet objectives.

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Appendix 1.

Box 1: Nigeria Excess Crude Account (ECA)

Nigeria can be classified as a classic rentier state (Bienen 1983; Kalu 2008; Khan 1994). Oil rents provide 80% of state revenues, which are shared among the federal and state governments. Oil revenues have been poorly managed at both levels of government, as witnessed by the country's still relatively poor infrastructure. However, in 2003 the economic team of then President Olusegun Obasanjo introduced a conservative oil benchmark price and set up the ECA, which came into effect in 2004. The goal was to tame the destructive pattern of volatile spending. Essentially, the parliament set up a fiscal rule that allocates oil revenues based on the volume of production and the budgeted price of oil. Any oil revenues exceeding this benchmark price were transferred into the Excess Crude Account. As the rapid upsurge in oil prices during the period, the ECA accumulated 20 billion dollars by the end of 2008.

The ECA began with a seemingly good start, which coincided with the repayment of Nigeria's external debt, but it soon failed in its purpose. Policymakers at the national and state level exhausted about 17 billion dollars of these funds, which were tapped at regular intervals, largely in an ad hoc and discretionary manner, by both former President Obasanjo and his successor the late President Umaru Yar'Adua. The latter appeased state governors, granting them access to the fund. As such, the ECA did not stop the volatile spending cycle, and the withdrawals were not used toward long-term development objectives. The withdrawals did nothing to improve the quality and quantity of infrastructure even though a majority of the outflows were designated for this purpose.

The failure of the ECA can be attributed to a number of factors. On the one hand, the ECA was not established as a separate SWF institution, underwritten by a firm set of governance principles establishing operational guidelines, a clear mission, and relative autonomy from bureaucratic and political encroachment. On the other hand, federal and state governments did not provide credible commitment to the long-term success of the ECA. This is simply a reflection of the ongoing struggles over the allocation of resource rents, where federal and state spending has come to depend significantly on oil rents.

In April 2010, it was announced that Nigeria was actively looking into establishing a new and legal SWF that would replace the ECA. In July 2010, the plan for the new fund stalled, as the Governors (who enjoyed the benefits of the ECA) struck back, as they wanted to protect their access to the ECA. Nonetheless, the Governors were later convinced of the need to adopt a proper commitment mechanism at the national level for managing resource rents. In August 2010 it was announced that a new SWF would receive an earmark of 1 billion dollars, and the following month President Goodluck Jonathan officially sent a bill to Parliament to create the fund, with the express purpose of underpinning national savings. As of this writing, the bill has yet to pass in parliament, and it is not clear if it will be successful. The prevailing political conditions can still scuttle the development of a new SWF, despite high rhetoric on the need for a well-governed SWF.

Box 2: Botswana Pula Fund

In comparison to most of sub-Saharan Africa and other resource-rich countries, not to mention other landlocked countries, Botswana, a country of 2 million people, is largely considered an economic success story (Acemoglu et al. 2001). At independence from Britain in 1966, which was peaceful, Botswana had only 12 kilometers of paved road, and the vast majority of the population lacked secondary education. But in the four decades since, Botswana has been one of the fastest growing economies in the world, transforming itself from one of the poorest countries in the world to a middle-income country with a per capita GDP of 13,100 dollars in 2010. Such fast growth is partly due to the country's vast diamond wealth, but also to consistent and sound economic management buttressed by non-violent political stability and high regulatory quality. Indeed, Botswana has had continuous civilian rule and one of the longest running multiparty democracies in Africa. As a result, Botswana is considered to be one of the least corrupt countries in Africa.[2]

The mining sector represents roughly 40% of GDP, but state expenditure is not solely reliant on resource revenue, as the state receives tax revenue from non-mineral activities (Iimi 2006). This has helped limit resource dependence and the creation of a rentier state, while contributing to transparency and accountability. Management of Botswana's resource wealth has followed a prudent trajectory. The state's budget philosophy follows the 'budget sustainability ratio' or 'Sustainable Budget Index'. This implicit self-disciplinary rule aims to maintain recurrent non-health and non-education spending equal to or less than non-mineral revenue. As such, mineral revenue is supposed to finance investment expenditure, which is defined as recurrent spending on health and education. To facilitate this budget philosophy, the state has set-up a long-term savings vehicle, the Pula Fund.

The Pula Fund was established in 1994 with the aim of preserving part of the income from diamond exports for future generations, and for managing foreign exchange reserves that are in excess of expected needs over the medium term. By creating a separate investment portfolio, appropriate considerations vis-à-vis long-term investment are incorporated in the guidelines for the fund's management. The fund invests in public equity and fixed-income instruments in industrialized economies. Its goal is to maximize returns. The fund does not invest in commodity exporting countries in order to hedge against decreases in commodity prices. Currently the Pula Fund has roughly 6.5 billion dollars in assets under management.[3] While there are benefits to the inclusion of the fund at the Bank of Botswana, given that the latter generally has a good track record of macroeconomic oversight and good governance, creating a separate stand-alone entity would potentially facilitate strategic investments.

While this picture of economic growth, sound governance and political stability is impressive, it is important to recognize that Botswana still has a number of significant development challenges: inequality is high; some rural areas are neglected and underdeveloped; minority groups, particularly the San, face discrimination; and, of considerable concern, nearly a quarter of the population is infected with HIV/AIDS. However, the country does have one of the most progressive and comprehensive programs for dealing with HIV/AIDs in Africa (Hillbom 2008). These development challenges place the country on a backward footing and heighten the long-term risks to depending on the mining sector. If such conditions intensify, it is not unforeseeable that the Pula Fund could lose popular support (though elite capture could still underwrite its continued performance and success). Said slightly differently, the Pula Fund's role in facilitating development through the prudent management of the country's resource wealth could be compromised if other development challenges are not effectively mitigated.

[2] Botswana receives the highest score (5.6) for Africa on the Transparency International Corruptions Perceptions Index 2010. Available at www.transparency.org. [Accessed 23 February 2011]
[3] See www.bankofbotswana.bw. [Accessed 23 February 2011]