

Policy Brief

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Sovereign stabilization funds and the end of the commodities super-cycle: what are the challenges?

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Summary:

Sovereign wealth funds, a major focus during the 2000s, should see their role strengthen as an economic «stabilizer» in the coming months, due to the fall of commodity prices. These investment vehicles must however be coordinated with the traditional fiscal policy tools and can free the government to do more or less long-term budget adjustments that the new international economic environment imposes.

In the mid 2000s, the media and political spheres discovered what they thought to be a new type of investor coming mostly from the Gulf countries and Asia: sovereign wealth funds (SWF). Sometimes arousing mistrust due to some of their opacity, then courted after the 2008 financial crisis, they have confirmed themselves not only as leading financial players but also as one of the logical consequences of economic rebalancing, making the countries that introduce them become the creditors of the Western world. Although subjects of much economic and political debate, in reality SWFs are quite old: the first one, the Kuwait Investment Office (now the Kuwait Investment Authority) was created in 1953. However, with the considerable rise in commodities prices that the world experienced before 2008 they assumed the financial aspect that they are now know for. Yet the drop in energy prices observed for several months did not diminish their strategic importance, quite the opposite: they were specifically established to increase the economic resilience of oil countries confronted with the depletion of their reserves and the price variability of these resources.

Bringing together all the public investment structures (or under public mandate) financed by recurrent resources, whether related to the exploitation of oil, gas and mining¹ or to the existence of large current account surpluses, SWFs are unique investors due to their macroeconomic role as well as their investment constraints: for some, the international dimension of their investments is a major distinguishing feature of sovereign funds.²

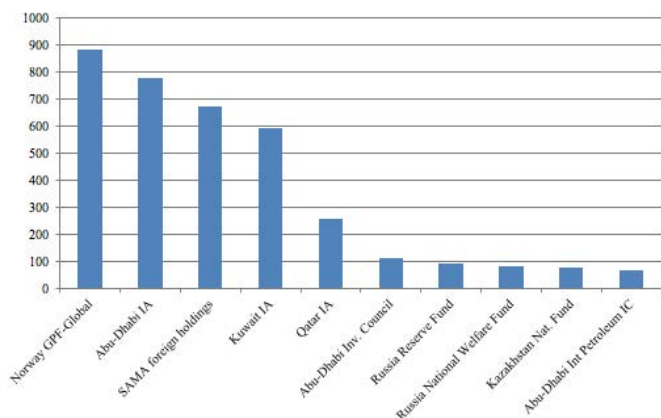
In addition, it is traditionally recognized that SWFs have no contractual obligation to liability and therefore must be distinguished from other public investment structures that may exist such as state pension funds, public development banks, or even state enterprises (Jégourel, 2012). Whatever the selected scope, their financial strength is considerable. In 2015, the largest SWF, the Norwegian sovereign fund called Government Pension Fund Global (GPF), managed nearly \$900 billion in assets, compared to the second largest, the Abu Dhabi Investment Authority, at 770 billion (Chart 1). An estimated \$6,300 billion in assets were managed in 2015 by these types of investors around the world, up more than 75% since December 2010.

1. The sovereign funds that have their origin in mining are more rare than those financed by oil, but are similar to the Pula Fund established in Botswana, the Copper Stabilization Fund established in Chile, or the stabilization fund of the US state of Wyoming.

2. This statement must be qualified, however: in recent years with Western financial crisis, there has been a shift in SWF investments towards domestic assets.

« Although subjects of much economic and political debate, in reality SWFs are quite old.»

Chart 1: Assets held by sovereign funds that have their origin in raw materials.³ (June 2015, USD billion)



Source: SWF Institute

Qualified by a common word, SWFs are nonetheless heterogeneous and complex structures for different objectives that are not mutually exclusive. If we stick to the categories proposed by the International Monetary Fund (IMF, 2008), four main types of SWFs can be identified. Like the Norwegian fund, intergenerational funds aim to evenly distribute the oil wealth by generating revenue streams to benefit future generations. Like the Chinese sovereign wealth funds (CIC and Safe⁴) financed by a surplus in the current account, others simply aim to improve the risk-return from excess foreign reserves by investing them in riskier and therefore more profitable assets, such as stocks or certain bonds. Noting the finite nature of the resources exploited, diversification or development SWFs in turn invest in diverse economic sectors, mostly abroad, to promote the long-term development of sustainable and independent revenue for the extractive industry and primary processing. By this they aim to mitigate the “Dutch disease,” a well-known economic phenomenon in which an economy gradually sees its traditional industrial sector weaken or disappear under the effect of capital inflows and the appreciation of the real exchange rate that follows. The last type, known as a stabilization or reserve fund, also aims to reduce an economy’s dependence on the raw materials sector, but in a cyclical sense. Their aim is indeed to protect the country that creates them from adverse effects, particularly in terms of public spending, economic growth, and income volatility linked to the export of commodities. The volatility of commodity prices creates unstable tax revenue and thus forces the implementation of fiscal policy (Varangis and Claessens, 1994). Within such a context, it becomes difficult for

the country in question to commit investment spending, particularly in infrastructure, which is however known to be a key to long-term economic growth. The existence of a stabilization fund allows, in principle, to counter the macroeconomic effects of such instability since a fraction of the revenue capitalized during bullish periods can be mobilized as soon as the situation is reversed, like the Russian reserve fund which in 2015 has increased the state budget by nearly USD 13 billion to cope with the fall in oil prices and the consequent decrease in tax revenue. Thus, as emphasized by Agénor (2015), a stabilization fund should complement the implementation of a budget rule (or a set of rules) so that the imperative of sustainability does not lead, during times of sharp declines in the prices of exported commodities, to a too abrupt adjustment of public expenditure, and can thus reaffirm the credibility of the rules.

« The international dimension of their investments is a major distinguishing feature of sovereign funds. »

Recognition of the heterogeneity characterizing SWF is essential. It explains why they cannot inherently all follow the same financial strategies. Stabilization funds traditionally invest in assets considered safe and sufficiently liquid to be sold quickly, while others may engage in these so-called alternative asset classes such as real estate, infrastructure and private equity. This heterogeneity consecutively explains why the outlook on their financial and macroeconomic performance must be differentiated. The decrease in assets of a stabilization fund appears perfectly logical in an economic downturn while it may be the manifestation of a mistaken investment strategy in the case of a diversification fund. Several academic studies have been conducted to assess the ability of stabilization fund to meet the objectives that were set for them. These include whether the existence of such an investment vehicle has an impact on the fiscal stability of a nation or, more generally, on macroeconomic stability (Shabsigh and Ilahi, 2007). The question is neither trivial nor simple, for several reasons.

« Although it is difficult to reach a definitive conclusion about the effectiveness of such funds while the governing operational rules -and the ability to respect them- differ between nations, a consensus seems to be emerging to recognize their long term macroeconomic relevance.»

First, the establishment of a stabilization fund does not guarantee, as such, the adoption of parsimonious behavior

3. Chinese and Singaporean sovereign funds of major importance, but not financed by oil or gas revenues are not presented in this graph.

4. China Investment Corporation and State Administration of Foreign Exchange.

during bullish periods. In the context of the famous “super commodities cycle” that producing economies have come to know, the turning point was hardly anticipated and the idea that the rise in prices would persist in the long term was engrained in people’s consciousness. The “greed” effect evoked by Tornell and Lane (1999) could then prevail and public spending would increase more than reasonably. Secondly, as Aoun and Baker (2015) stressed, stabilization funds have sometimes changed their investment strategy, from “prudent” management logic of financial windfalls received to the more ambitious but also riskier, long-term investments (Hassan et al. 2013). From this perspective, the concept of stabilization funds is as much semantic as economic since some funds such as the KIA or the State Oil Fund of the Azerbaijan Republic (SOFAZ) actually follow several objectives. Third, the countercyclical effect expected from a stabilization fund depends on its maturity. Compelled to invest in a priori relatively liquid assets, and as such, with low returns, indeed it must be established early enough so that the assets available to it, from the employer’s contribution and acquired compensation, can be mobilized. However, experience shows that this is not always the case, such as the case of Nigeria that manages, through the Nigerian Sovereign Investment Authority (NSIA), three sovereign wealth funds. One of them is certainly dedicated to the macroeconomic stabilization of this oil economy, but with only 20% of the NSIA resources, it does not have sufficient financial strength to be a relevant response to the current fall in crude prices. Defining the rules for resource allocation and withdrawal of a stabilization fund have, in this context, considerable importance (Agénor, 2015). The optimality of fiscal support measures from the stabilization fund should be questioned in particular during a bear market: they cannot threaten the sustainability of the funds and their effectiveness should be compared and / or combined with those of other budgetary measures, including increased tax revenues and / or a reduction in public expenditure (Aslanki, 2015). Lastly, it is possible that some funds, for which the governance structure is highly dependent on the political establishment, have either been misused to finance the acquisition of loss-making public enterprises (Davis et al, 2001) or was used to maintain a budgetary “balance” threatened by economic sanctions to which their countries were subject.

« The establishment of a stabilization fund does not guarantee, as such, the adoption of parsimonious behavior during bullish periods.»

Although it is difficult to reach a definitive conclusion on the effectiveness of such funds while the governing operational rules -and the ability to respect them- differ

between nations, a consensus seems to be emerging to recognize their long-term macroeconomic relevance. A 2001 study by economists from the International Monetary Fund (IMF) on five of the twelve countries with a sovereign wealth fund (Chile, Kuwait, Norway, Oman, Papua New Guinea) certainly shows that the positive relationship between government spending and export earnings was not, for the periods in question (twenty years on average), affected by the implementation of such an investment vehicle (Davis et al., 2001). This vehicle, in other words, does not favor the adoption of a greater fiscal discipline to capitalize on export earnings when they are considerable. Further analysis also confirms the idea that, for some countries, excessive mobilization of assets held by the stabilization fund limits the use of austerity policies, which are necessary when commodity prices collapse. A more recent study, also conducted by the IMF (Sugawara, 2014), however, confirms the merits of the stabilization fund and demonstrates that, for the 68 countries considered over the period 1988-2012, the presence of a stabilization fund enables to smooth out budget expenditures.

Concerning sovereign funds from Norway, Chile, Alaska, Kuwait, and Oman, Fassano (2000) had also suggested that these funds not only make it possible to improve the effectiveness of fiscal policy by decoupling it in part from the availability of income, but also to accentuate the incentive to not to increase public spending in good times, by investing the excess income in a dedicated vehicle. Considering macroeconomic stability rather than just budgetary stability, Shabsigh and Ilahi (2007) show meanwhile that the use of such instruments has a favorable impact on the macroeconomic conditions of nations that use them by reducing inflation, volatility in the money supply and, to a lesser extent, the volatility of the real exchange rate.

From these elements we will understand that the use of a stabilization fund is a matter of arbitration and measurement. The collapse of commodity prices that has occurred over the past months will, if it persists, put the government’s capacities to the test. In these stabilization funds they will find part of the resources they lack to ensure the continuity of their actions, but they will not, so far, dispense with the need to adjust the medium to long-term fiscal policy, including their operating expenses, to the new macroeconomic environment.

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