Sovereign Wealth Fund in Zambia

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Abstract

Sovereign Wealth Funds (SWFs) are pools of assets owned and managed directly or indirectly by governments to achieve national objectives. Typically they are funded by foreign exchange reserves, royalties on the sale of natural resources, or general tax revenues. Aside from the obvious funding for socioeconomic objectives in the country this paper aims to address the persistent problem of low reserves by proposing a sovereign wealth fund.

Keywords: Sovereign Wealth Fund, Zambia

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Nature of sovereign wealth funds

Before we dive into the subject of sovereign wealth funds we must firstly admit that to a large extent we are stepping into unchartered waters with some navigation globally and most importantly unchartered waters with no navigation locally for Zambia. In fact according to (Kemme, 2012), while there is now a substantial literature on the general nature of sovereign wealth funds, it lacks specificity in part because the data is sketchy and difficult to compare from fund to fund. The issues concerning sovereign wealth funds, from corporate governance and transparency to investment policies and implications, are very contentious and many are unresolved.

Defining Sovereign Funds

Sovereign Wealth Funds (SWFs) are pools of assets owned and managed directly or indirectly by governments to achieve national objectives." (Blundell-Wignall, et al., 2008) Typically they are funded by foreign exchange reserves, royalties on the sale of natural resources, or general tax revenues.

The IMF has identified five types of funds based on their main objective (IMF, 2008):

1) Stabilization funds, designed to insulate the national budget and domestic economy from commodity price swings, usually oil,

2) Savings funds, designed to realize and convert natural resource wealth into more diversified assets for future generations and mitigate the effects of Dutch disease,

3) Reserve investment corporations, designed to increase the return on foreign reserve assets (which otherwise are typically invested in very short term assets to be available for currency exchange rate management purposes),

4) Development funds, designed to support socio-economic projects, promote industrial policies or overall development objectives, and

5) Pension reserve funds, which fund national pension systems (from sources independent of individual contributions) or provide for unspecified contingent liabilities.

The funds often have multiple, overlapping and evolving objectives. In addition, their purpose has often been broadened.

International Practice

Origins

According to (Balin, 2008) the first sovereign wealth funds were established alongside the initial oil strikes in the Persian Gulf states in the 1950s the Kuwaiti Investment Board, for example, began in 1953 for the purpose of managing the "excess" oil revenues Kuwait was expected to garner in the coming years. The next wave of funds was established during the oil boom of the 1970s. Oil exporters such as the United Arab Emirates, Saudi Arabia, and Alberta used their SWFs as a way to absorb excess liquidity that could potentially overheat their economies. Recently, another oil and natural resources boom alongside a massive build-up of foreign exchange reserves among non-commodity exporters has spurred a new group of countries to establish sovereign wealth funds. These countries, including South Korea, Venezuela, Iran, and Algeria, are much more geographically and economically diverse than their older counterparts. Many of these newer funds represent countries that are not commodity exporters, are not necessarily facing excessive financial liquidity, and are oftentimes still quite economically underdeveloped a far cry from the "overabundance" scenarios that spurred the first two rounds of sovereign funds. Additionally, in the last ten years, the scope and size of all sovereign funds has changed. Although sovereign wealth funds are by no means a recent phenomenon, they have nearly doubled in size since 2000 from $1.5 to $3 trillion.

Purpose

Regarding their purposes, SWFs can be broadly categorized into two main types: savings and stabilization funds (Griffith-Jones & Ocampo, 2008). Savings funds are intended as permanent funds and are generally associated with non-renewable natural resources. They create a store of wealth for future generations so that they can benefit from the resources after their depletion. They build on economic theory which implies that part of non-renewable resources should be saved to smooth the country's inter-temporal consumption, in ways similar to individuals who save both for their retirement and to leave an inheritance to their children. A stabilization fund is a mechanism designed to reduce the impact of volatile fiscal revenues and/or foreign exchange receipts, linked to the pro-cyclical pattern of export prices or volumes. Stabilization funds often take the form of contingent funds, which accumulate resources when government revenues or the price of exports is high (above some threshold) and pay when they are low. A third category, sometimes mentioned separately (Davis, et al., 2003) is a financing fund, whose operational rules are explicitly designed so it effectively absorbs a budget surplus or funds an overall budget deficit. An example is the Norwegian Fund, where the budget has to transfer to the fund revenues if the budget is in overall surplus; if the budget is in deficit, the latter is financed by the fund.

According to (Balin, 2008) Sovereign wealth funds are established for four principal reasons. Firstly, most funds held by natural resource exporters act as intergenerational transfer mechanisms, where future government pensions, asset liquidity, and fiscal revenues are guaranteed by today's export earnings. When the country's natural resources are exhausted, therefore, future generations can continue to live prosperously using the earnings of their forefathers. Next, most sovereign wealth funds of all country types are created to diversify a country's income so that it can respond to shocks to the country's comparative advantages. When a country is faced with a competitiveness crisis, it can call on its sovereign wealth fund assets to reinvest in new sectors of the economy that can revive the country's competitive advantages. Thirdly, countries establish sovereign wealth funds to increase the return on assets held in their central bank reserves.

According (Bernstein, et al., 2013) Sovereign funds frequently have multiple goals, which different organizations emphasize to varying extents. There are three distinct roles sovereign wealth funds can play. First, they can serve as a source of capital for future generations, especially in countries where future generations may no longer be able to rely on commodities for a steady stream of revenue. For example, the nation of Kiribati is a collection of islands in the Pacific Ocean (formerly known as the Gilbert Islands) with a population of under 100,000 residents. For many decades, the dominant export from the country was guano, bird droppings used for fertilizer. The island's leaders up the Kiribati Revenue Equalization Reserve Fund in 1956, and imposed a tax on up the Kiribati Revenue Equalization Reserve Fund in 1956, and imposed a tax on production by foreign firms. The last guano was extracted in 1979, but the fund remains a key economic contributor. At $600 million, it is ten times the size of the nation's gross domestic product, and the interest generated by the fund represents 30 percent of the nation's revenue. Such a use is similar to that of a university that receives a major bequest: typically, these funds are not spent immediately, but instead added to its endowment so it can benefit many cohorts of students. Second, sovereign wealth funds can play a stabilizing role by reducing the volatility of government revenues. Countries that depend on commodities for the bulk of their exports revenues. Countries that depend on commodities for the bulk of their exports can be whipsawed by shifts in prices, as, for instance, many oil exporters were in the mid-1980s and late 1990s. Finally, these funds can serve as holding companies, in which the government places its strategic investments. Public leaders may see fit to invest in domestic or foreign firms for strategic purposes, and the sovereign funds provide a way to hold and manage these stakes.

There is also much debate about the legal forms that these sovereign funds may take. One example in Kuwait with the NOF. According to (Kemme, 2012) the NOF is not a legal entity, but instead a fund at the NBK established by Presidential decree, owned by the Ministry of Finance, overseen by a Management Council appointed by the President and managed by the Treasury Department of the

NBK. The Council sets governance and investment policies and the portfolio is managed by the NBK. Receipts consist of direct budget transfers (the initial endowment), direct taxes other oil sector receipts, revenues from privatization and sales of land, and investment income. Assets have grown steadily from just over US$8 billion in 2005 to US$41.6 billion in 2010. Uses of funds are: 1) "guaranteed transfers" to the government, which grew from US$2.1 billion in 2002 to US$8.1 billion in 2010, now limited by the "New Concept" to about US$8 billion annually, 2) "targeted transfers," direct transfers to SK in response to the financial crisis in 2008 and 2009, and 3) management expenses. The NOF has accumulated assets every year since its inception, with taxes from production sharing and royalties accounting for about two thirds of revenues, oil and gas lease payments accounting for another 20% and excess profits taxes and corporate income taxes accounting for about 9%. The NOF is designed to provide economic stability and savings for future generations.

Why Sovereign Wealth Funds

Many nations have failed to save the wealth created by developing natural resources. Consider, for instance, the experience of Norway in the 1970s and 1980s[1]. In the oil surge of those years, the government received a tremendous windfall of funds from its numerous rigs in the North Sea. While efforts were made to enact legislation that set aside money for the future, most of the money was spent immediately. Some of the spending benefited physical and social infrastructure: Norway rebuilt its excellent system of roads and bridges and provided free health care and higher education to all residents. But other expenditures were less beneficial for long-term growth. For example, minimum wages were set extremely high, which rendered a number of economic sectors uncompetitive in global markets, and industries were subsidized. Much of the funding for industry was earmarked for dying sectors, such as shipbuilding. This support allowed facilities to remain open for a few years more, but could not reverse the inexorable decline of such industries. Much of the funding for new ventures went to friends or relatives of parliamentarians or of the bureaucrats responsible for allocating the funds. Moreover, Norway's policy of aggressively spending the government's petroleum revenues brought chaos to public and private spending the government's petroleum revenues brought chaos to public and private finances when oil prices plunged in the mid-1980s. The government's oil revenue dropped from about $11.2 billion in 1985—to $2.4 billion in 1988.

Commodity based SWFs simply convert wealth in the form of natural resources in the ground into wealth held in more traditional financial assets. The new, more "spendable" form of wealth may generate increases in spending and GDP, generally a positive outcome, but the now realized wealth of the SWF may enable the continuation of undesirable macroeconomic and financial policies to the

[1] for more details, see Pope 1995; Gjedrem 2005

long run detriment of the country (Lu, et al., 2010). Governments must still provide sound macroeconomic policies: fiscal, monetary and exchange rate management. Market discipline could be lost and governments could make political decisions with adverse long run consequences because of the easy financing available if they can tap the SWF resources. The economic benefits may also be lost, if they existed at all. In fact (Aslund, 2007) claims "sovereign wealth funds are often a lousy bargain for the countries that have them" and in democracies there is no justification for their existence. It seems they are most prevalent in authoritarian, less developed countries where citizens cannot demand smarter economic policies. But, there is a clear trade-off as the benefits of a well-managed SWF with long run economic development objectives as a goal may prove beneficial in economies with no or underdeveloped capital markets.

While macroeconomic policies may be altered by the existence of SWFs, the management of the SWF in and of itself may cause even more serious issues regarding the efficiency with which resources are used, the pattern of economic development, and social and economic disruptions, legal or otherwise. Many SWFs lack clarity in their organizational structure, have ill-defined governance mechanisms, lack accountability and transparency and suffer from poorly designed or non-existent financial management policies. The lack of independent auditors or published annual reports and therefore very opaque balance sheets leaves room for behaviour that may be questionable (Kemme, 2012).

History of Industrial Development Corporation

Following the achievement of independence in 1964, the Zambian government sought to rely on the existing private sector as the basis of its development policy. The perceived failure of these measures prompted a reassessment of the policy and in 1968 the emphasis shifted towards state enterprise (Craig, 1999).

Initial Development Strategy

The independent Government outlined ambitious development objectives in the First National Development Plan (FNDP) in 1966 (Zambia, 1966). Objectives included

- The diversification of the economy so that it was not reliant solely upon mining; the increased domestic production of goods to meet local demand;
- The increasing of employment and real output per head; the minimizing of the inherited inequalities between the rural and urban sectors;
- The raising of the level of education and social welfare and the development of the economic and social infrastructure.

The role of state activism in the economy was conceived as being that of a catalyst, inducing and quickening private sector activity. As the Plan stated:

A vigorous investment policy by the Government is a prerequisite for dynamic private enterprise, especially when a large percentage of the investment is devoted to establishing the economic infrastructure which promotes the expansion of productive private investment.

INDECO

Zambia had inherited a diverse collection of around fifty state owned companies and statutory boards, some directly from the territorial government and some created from the splinters of divided federal institutions. They included utility industries such as railways and electricity, agricultural finance and marketing boards and an Industrial Development Corporation (INDECO).

Although previously used as an abbreviation, the name of the corporation was formally changed to INDECO Limited from 1st April 1970. INDECO was created by the colonial territorial government to act as a development agency, promoting private industry through finance and research. The Independent Government declared it to be its "principal instrument for the administration of industrial policy" and extended its role to include the promotion of specifically Zambian entrepreneurship and taking direct equity investment in projects. It was not, however, envisaged that the state sector would displace the dominant position of private enterprise in the industrial sector. As the Government stated in 1966;

There is no question of the Zambian Government nationalizing industries that are already in existence, the policy being for state ownership of certain new basic industries and for state participation jointly with private enterprise in certain others. The remainder of the industrial field is open to private investors and the Government has created a tempting investment climate to encourage the inflow of capital for private investment.

This was in line with the advice of the Seers Report (1964, p.80) that defined a role for Government as "an entrepreneur, either partially or completely, in industries where the private sector is not prepared to establish plants or is doing so to an insufficient extent," arguing that in such circumstances state participation could create greater confidence in the economy and encourage further private investment.

Expansion through INDECO 1964 to 1968

Although the Government undertook investment during this period through a number of institutions, INDECO was the primary vehicle through which this was undertaken.

While it continued to promote private enterprises after independence, INDECO increasingly became dominated by direct equity investments in state enterprises. Between 1964 and 1967 INDECO

expanded rapidly, its net assets rising from K2 million in FY 1964 to over K16 million in FY 1967. INDECO's portfolio changed markedly between FY 1964 and FY 1967, with equity investment, particularly in subsidiary companies, replacing loans as the principal form of investment activity undertaken.

INDECO's stated criteria for establishing state enterprises targeted industries which constituted domestic monopolies and were basic to the economy, or those in which the opportunity for utilizing local resources required a greater investment than private enterprise would contemplate.

By early 1968, INDECO had interests in 22 companies, of which were fully operational, and the remainders were in the process of initial development. They ranged from minority stakes in foreign transitional subsidiaries to wholly owned INDECO subsidiaries. The largest INDECO investments were in four associated companies (Chilanga Cement, Kafue Textiles, Zambia Sugar and Zambia-Tanzania Road Services), four INDECO subsidiaries (Zambia Clay Industries, TAZAMA Pipelines, Zambia Hotel Properties and Nitrogen Chemicals of Zambia) and two wholly owned INDECO subsidiaries (Zambia National Wholesaling Corporation and Zambia Steel and Building Supplies).

Although INDECO was establishing a major presence in Zambia's economy, its role in ownership was seen as transitory. The Seers Report had suggested that ownership could be transferred to private interests at subsidiary level through the sale of equity in enterprises to private interests or through the sale of shares in the corporation itself.

Problems of Development and Evolution of Policy

The economic strategy of the Government changed in direction in 1968. At the centre of this new approach was the expansion of both the size and the scope of the State Enterprise sector, and a restructuring of the state's relationship to private enterprise. The extension of state control over a wider group of enterprises was combined with an extension of the objectives to be pursued through the sector. The key to the expansion of the state sector was a series of take-overs between 1968 and 1970, aimed at the major expatriate and foreign owned enterprises that covered much of the economy.

The announcements of the takeovers were delivered in three speeches by President Kaunda at Mulungushi in 1968, at Matero Hall in 1969 and again at Mulungushi in 1970. In 1968 President Kaunda announced that INDECO would be taking over a number of private enterprises involved in the supply and manufacture of building materials, brewing, transportation, and retailing. These takeovers made INDECO the third largest company in Zambia behind the mining companies Anglo-American and RST. It was to these latter companies that attention turned in 1969, when President Kaunda announced

the takeover of 51 percent of their mining interests. Finally in 1970 President Kaunda turned his attention to the financial sector and announced plans to take over a number of financial institutions along with a further tranche of other enterprises. This represented the end of the period of major takeovers and while further acquisition occurred, they were incremental.

IDC

The Industrial Development Corporation (IDC) Limited is a State-Owned Enterprise (SOE) charged with the mandate to spearhead the Zambian Government's commercial investments agenda aimed at strengthening Zambia's industrial base and job creation.

The IDC was incorporated in January 2014 and is wholly owned by the Government through the Minister of Finance pursuant to the Minister of Finance (Incorporation) Act Cap 349 of the Laws of Zambia.

The IDC was established to create and maximise long-term shareholder value as an active investor and shareholder of successful state-owned enterprises, as well as undertake industrialisation and rural development activities through the creation of new industries.

The IDC's corporate strategy of 2017 outlines the company's strategic focus during the next five years. It also outlines the role the IDC will play in the industrialisation agenda for the country. Using this plan, the IDC seeks to position itself to be Government's principal special purpose vehicle for industrialisation and investment acceleration.

Establishing a Sovereign Wealth fund in Zambia

Aside from the obvious funding for socioeconomic objectives in the country we must address the persistent problem of low reserves despite years of higher copper production. Zambia needs to accumulate foreign exchange reserves.

Motives for accumulating foreign exchange reserves by developing countries are associated with the attempt to mitigate the volatility of exchange rates caused by terms of trade shocks and the vulnerability due to financial openness. (Aizenman & R. Glick, 2007) Found that accumulating foreign exchange reserves mitigates the real exchange rate effects of term of trade shocks, and that this mitigation is especially important for exporters of natural resources. On average, natural resource dependence doubles both the impact of terms of trade shocks on the real exchange rate and the mitigation associated with accumulating foreign exchange reserves. This is very relevant for developing countries as there is growing empirical evidence that mitigating real exchange rate volatility increases growth. Aghion et al. (2006), for example, provide empirical evidence that exchange rate volatility reduces growth. Furthermore, higher international reserves/GDP increases

the ability of smoothing adjustment to shocks, which is optimal in an open economy, in the framework of the permanent income hypothesis (Aizenmann, 2006).

At first blush, sovereign wealth funds might seem an excellent opportunity for nations with high variance in public revenues to ensure steady cash flow levels for nations with high variance in public revenues: for example, countries relying on and provide resources for long-term investments: for example, countries relying on commodity trade that occasionally encounter windfalls of natural resources. Such commodity trade that occasionally encounter windfalls of natural resources. Such countries, without a fund to direct investments, could otherwise fall prey to the countries, without a fund to direct investments, could otherwise fall prey to the "Dutch disease" and squander short-lived windfalls from natural resources in a way that weakens the economy's long-run potential. But sovereign wealth funds also have limitations, since they may create economic distortions. For example, there have limitations, since they may create economic distortions. For example, there are concerns about lack of transparency and political capture: funds with political are concerns about lack of transparency and political capture: funds with political leaders on their boards may be tempted to shore-up domestic firms as they succumb leaders on their boards may be tempted to shore-up domestic firms as they succumb to political pressure, passing up on high net present value investments in other firms and creating product market distortions by favouring connected or poorly firms and creating product market distortions by favouring connected or poorly performing firms. Similarly, as the interaction between sovereign wealth funds and political agenda grows, opportunities for nepotism increase, potentially reducing the overall skill of sovereign wealth fund managers relative to professionals and diluting the returns.

In 2017 a research paper by (Shula, 2017) presented a new view on how Zambia could tackle both debt and inflation using this strategy. The idea proposed here was not a conventional Sovereign wealth fund but it would operate on similar lines as it would be a government investment vehicle that invested in domestic currency and foreign denominated assets and whose management would be ancillary to official reserves. The key would be to anchor the Zambian currency in copper reserves, a commodity which Zambia has a natural endowment and not necessarily a comparative advantage.

A recent discovery of more gold deposits in parts of the country also add more fire to this spark. The issues of legislation and political will be unavoidable but ultimately surmountable.

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