Funding The Future

How Sovereign Wealth Funds benefit future generations

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The Intergenerational Foundation (www.if.org.uk) is an independent, non-party-political charity that exists to protect the rights of younger and future generations in British policy-making.

Whilst increasing longevity is to be welcomed, our changing national demographic and expectations of entitlement are placing increasingly heavy burdens on younger and future generations. From housing, health and education to employment, taxation, pensions, voting, spending and environmental degradation, younger generations are under increasing pressure to maintain the intergenerational compact whilst losing out disproportionately to older, wealthier cohorts.

IF questions this status quo, calling instead for sustainable long-term policies that ensure younger and future generations are better protected by policy-makers.

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Foreword

Many countries have set up sovereign wealth funds (SWFs) and this report explains what these are, how they work, how big each of them has grown to and the intergenerational implications. It is striking that the Norwegian fund, built up from oil revenues, now represents a value of over $500,000 for each Norwegian family, and that on average that fund now owns 2.2% of all European quoted shares.

The issue has recently been put back into public debate with the Scottish Nationalists arguing that Britain should have used its oil revenues to build up a UK sovereign wealth fund, and they imply that if Scotland gained independence they would do just that.

The UK is today in a fiscally bleak position with an official public debt of over a trillion pounds (about £40,000 for each UK household) and a pension liability of about five times this amount (about £200,000 for each UK household). The UK's debts continue to rise and the much debated "budget deficit" simply measures how much extra debt is added each year. It may therefore seem optimistic even to discuss the possibility of a SWF for the UK. On the other hand, this report highlights two very different attitudes: those who are concerned about future generations and build up their SWFs, and those who simply borrow as much as the markets will allow. It also maps out for different countries how a steadily accumulating surplus can be effective in protecting future generations.

It is hoped that this report will demonstrate the forward-thinking behaviour of some countries and encourage a change in attitude amongst British policy-makers so that future generations are taken more seriously and their needs better provided for.

Angus Hanton

Co-founder, Intergenerational Foundation

What is a sovereign wealth fund?

A SWF is a state-owned investment fund, often financed by foreign-exchange assets, which invests globally. They are typically created when governments have budgetary surpluses and little or no international debt.

Usually, these funds are set up with one or more of the following objectives:[1]

- to insulate the budget and economy from extreme volatility in revenues,
- to help monetary authorities manage excess liquidity,
- to develop domestic infrastructure,
- to build up savings for future generations.

The importance of SWFs for intergenerational equity is at once clear. Not only do they build up vital savings for future generations but they also act in the present to stabilise potentially unpredictable economies in resource-rich countries by diversifying their sources of income.

As such, SWFs are often broadly divided into two types:

- Stabilisation funds, created to counteract the adverse effect of "boom-bust" market cycles on government spending and the national economy.
- Saving funds, created with a view to building up savings for future generations.

For countries rich in a specific raw material, SWFs can be especially useful: they help to protect the economy against the high volatility of resource prices and the unpredictability of extraction. Resource-rich countries can reduce their dependence on a single commodity by investing the returns in a greater range of industries. In doing so, they can create a more complex infrastructure and a greater number of jobs on a national scale.

Moreover, SWFs in resource-rich countries can help to negotiate the unavoidable issue that resources are constantly being depleted and, one day, will be exhausted completely.

Sage investment, via the creation of a SWF, can halt the valid criticism that the current generation is giddily consuming their national resources at the expense of the prosperity and financial wellbeing of the next. With the aid of sovereign wealth enterprises, countries are able to transform oil receipts into other, more sustainable forms of wealth, rather than carelessly consuming them.[2] By creating a broader base for economic growth, they act now to prepare themselves for a post-commodity era in the future.

The intergenerational objective

The sheer volume of sovereign investment funds which have sprung up in recent years reveal just how much SWFs appeal to many countries.

The total worth of assets held under management by SWFs increased to **$4.62 trillion** worldwide 2012, up 16% from 2011,[3] more than the world's hedge funds combined.[4] SWF assets are projected to surpass the stock of global foreign-exchange reserves in the not so distant future and to top **US$7-11 trillion** during 2013.[5]

Fig.1 Sovereign Wealth Funds Created in the last five years[6]

Country	Fund	Assets	Begun	Origin
North Dakota	North Dakota Legacy Fund	$0.1 Bn	2011	Oil & Gas
Papua New Guinea	Papua New Guinea Sovereign Wealth Fund	Unknown	2011	Gas
Nigeria	Nigerian Sovereign Investment Authority	$1 Bn	2011	Oil
Mongolia	Fiscal Stability Fund	Unknown	2011	Minerals
Italy	Italian Strategic Fund	$1.4 Bn	2011	Non Commodity
Saudi Arabia	Public Investment Fund	$5.3 Bn	2008	Oil
Russia	National Welfare Fund	$149.7 Bn	2008	Oil
France	Strategic Investment Fund	$28 Bn	2008	Non Commodity
Brazil	Sovereign Fund of Brazil	$11.3 Bn	2008	Non Commodity
UAE – Federal	Emirates Investment Authority	Unknown	2007	Oil
UAE – Abu Dhabi	Abu Dhabi Investment Council	Unknown	2007	Oil
China	China Investment Corporation	$439.6 Bn	2007	Non Commodity
China	China-Africa Development Fund	$5.0 Bn	2007	Non Commodity
Chile	Social and Economic Stabilization Fund	$15 Bn	2007	Copper

All SWFs share the goal of efficiently and effectively managing their country's official financial wealth. The recent proliferation of SWFs is probably due, in large part, to the current price of oil, which has recently reached near-unprecedented levels. However, many of these more recent SWFs are motivated by more than a desire to manage successfully the huge revenues derived from natural resources. They are also driven to establish SWFs on account of intergenerational concerns. If we look to the rhetoric and to the ideals with which these organisations present themselves to their nation and to the world, we may note a growing trend to voice concerns about their impact on future generations.

The Papua New Guinea Sovereign Wealth Fund claims the ultimate goal of protecting the economy and to aid the long-term economic and social development aims of the country by safeguarding resource revenues.[7]

Russia's National Welfare Fund, created in 2008 with $32Bn, had risen to $85.21Bn by August 2012.[8] Its mission statement claims that the NWF is dedicated to supporting the pension system of the Russian Federation to guarantee the long-term sound functioning of the system. The fund looks to "co-finance" the voluntary pension savings of Russian citizens and to balance the budget of the Pension Fund of the Russian Federation.[9] The SWF looks essential when one considers the ticking time-bomb that is the Russian Pension system. Like many post-industrial countries, Russia and its ageing population have seen the vital need to create a fund to help them deal with future social obligations. Russia's SWF aims to subsidise the long-term fiscal liabilities and responsibilities of the pension system, a problem which many countries without SWFs share but are unable to confront successfully.

The Pension Reserve Fund (PRF) of Chile had an initial contribution of US$ 604.5 million and now boasts an estimated worth of US 4.4 billion. This fund receives an annual contribution of between 0.2% and 0.5% of GDP.[10] It was set up in response to Chile's new demographic pressures which are characterised by an increase in life expectancy and the growth of its elderly population

Sovereign wealth funds facilitate a transfer of wealth from one generation to the next and institutionalise a fiscally responsible mentality.

Tanzania's SWF, although still in the planning stages, also claims an intergenerational objective. President Kikwete plans to use the fund to finance development projects in the future.[11] With natural gas revenues worth up to $3Bn a year (as estimated by the World Bank), he hopes to speed up the development of infrastructure, science and technology which would see the country transformed into a middle upper income economy by 2040. The existence of a successful SWF would play a key part in advancing the National Development Vision 2025, which looks to the economic, social, political and cultural progress of Tanzania.

Despite the obvious attractions of establishing a SWF, a dilemma immediately arises for countries considering the creation of a SWF: whether to look to the future or to plough their funds straight back into current infrastructure projects.

The media maelstrom that envelops Australia's Future Fund highlights the fierce debate that surrounds the decision to spend or to save.

Guy Fowler, head of investment banking at UBS Australasia, urges Australians to capitalise on the current favourable market conditions. He argues that when their resources are inevitably depleted, they will have nothing to show for it.[12] Rather than squandering their significant mineral wealth they should – he claims – invest wisely now in order to provide for future generations.

By contrast, Peter Costello, Future Fund guardian and former treasurer, in opposition, claims that the creation of a new SWF, or heavy further investment into their existing SWF, would be inappropriate since Australia is currently struggling with a budget deficit of $40 billion with an aggregate deficit of $120 billion. Costello argues that the reduction of this should be the country's primary concern.

Even when not dealing with a deficit, in the short-sighted world of politics the temptation is to spend rather than to save. In circumstances where the government is short of money, there is always an additional temptation to raid the resources of future generations.

An efficient balance between current domestic spending and investing in foreign assets for the future is politically difficult to sustain, as there will always be competing demands for current consumption at home. This is especially true in times of economic turbulence.

However, in the midst of commodity booms, it is prudent to save some public wealth to prepare for the challenges of tomorrow and to support the generations of tomorrow.

Saudi Arabia's central bank, which had accumulated significant excess foreign reserves since the 1970s, was able to cushion the severity of a decade of slow growth by infusing money into the Saudi economy. The Kuwait Investment Authority was instrumental in rebuilding the Kuwaiti economy in the aftermath of the invasion of Kuwait and the 1990 Gulf War.[13]
Outside of their own countries, SWFs provided vital bailout capital in 2008 to financial-sector heavyweights such as Citigroup, Merrill Lynch, UBS and Morgan Stanley.[14]

Nigeria has approached this dilemma uniquely, attempting to hedge its bets by acknowledging the benefits of both spending and saving.[15] The National Executive Council decided upon a $1 billion Sovereign Wealth Fund (SWF) at the end of June 2012 which will be split into three different funds: an infrastructure fund, a stabilisation fund and a future generations fund.

- Firstly, the Infrastructure Fund will be used to develop critical facilities across the country. Notably, 10% of this fund will be devoted to agriculture and regional government-sponsored development projects that will promote economic development in under-served regions in Nigeria.

- The Future Generations Fund will be used to build an intergenerational savings base by investing in longer-term assets that generate returns to accumulate wealth for future generations of Nigerians.

- Finally, the Stabilisation Fund will be used to protect the country's budget by providing a stable source of finances during periods of fiscal deficit and to ensure the smooth functioning of government when revenues from petroleum sales are less than expected.

The success of resource-rich countries

Out of the fourteen SWFs created in the last five years, nine have abundant natural resources to thank for their initial investment.

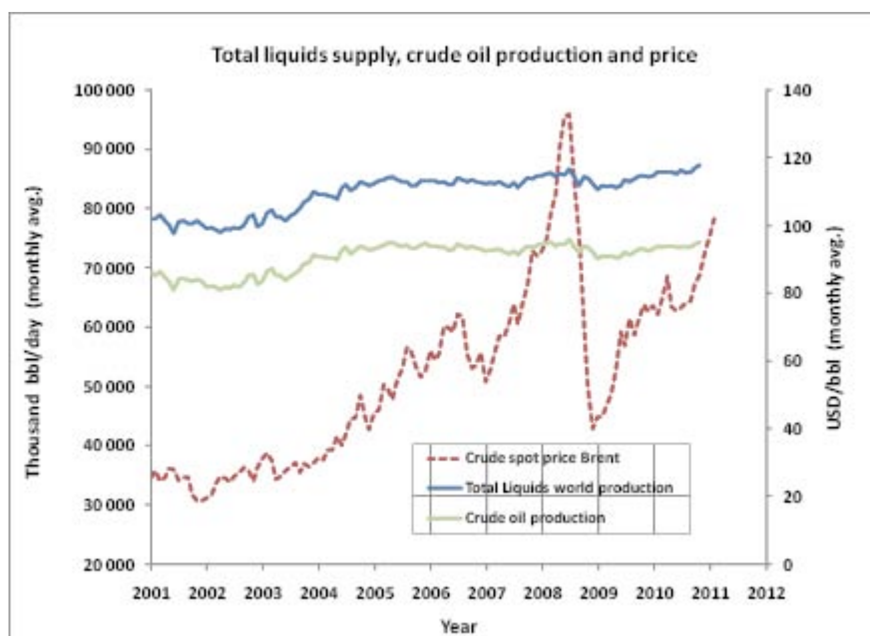
Out of the fifteen biggest oil producers, only Iraq does not yet have a SWF. Norway, Algeria, Venezuela, Kuwait, Nigeria, Brazil, UAE, Mexico, Canada, Iran, China, the USA, Russia and Saudi Arabia all have at least one SWF.

Oil-producing countries are estimated to account for two-thirds of the assets held by these sovereign wealth funds;[16] these nations are keen to vary and expand their national revenues, aware that, if they fail to act now, their wealth will swiftly be pumped away.

The long term, intergenerational incentives for oil-rich countries to create a SWF are twofold.

Firstly, oil prices are currently rocketing, surpassed only by a spike in 2008. Oil is now selling at around $100/barrel. The current revenue from the petroleum sector is estimated by many to be at its peak period and projected to decline over the coming decades.[17] Moreover, oil prices, regardless of longer-term trends, are consistently volatile. Thus it is a wise move to invest actual or potential oil-sourced income in foreign assets, since this would protect against fluctuating prices and the predicted future decline in oil-value – and the concomitant decline in income for these countries.

Fig. 2 The volatile oil market[18]



Secondly, extracting and selling oil amounts to running down capital, unless the receipts are fully reinvested in financial, physical, environmental or human capital (Hartwick's Rule for intergenerational equity[19]).

The Arab peninsula in particular exports oil to the tune of $1trillion per annum,[20] and many countries have seized the chance to secure this wealth.

Within even a few years, several of these Middle Eastern Funds have invested wisely enough to have made billions out of the volatile revenues derived from their natural resources and, in doing so, have provided for the future. Notable examples are Qatar, Dubai and Libya. With good fund management, there is potential for other oil-rich countries to capitalise on their current assets and stabilise their financial prospects for the benefit of future generations.

Fig. 3 SWFs in Middle Eastern Countries[21]

Country	Fund Name	Asset: $Bn	Begun	Origin
Kuwait	Kuwait Investment Authority	$296	1953	Oil
UAE – Abu Dhabi	Abu Dhabi Investment Authority	$627	1976	Oil
Oman	State General Reserve Fund	$8.2	1980	Oil & Gas
UAE – Abu Dhabi	Int. Petroleum Investment Company	$65.3	1984	Oil
Azerbaijan	State Oil Fund	$30.2	1999	Oil
Iran	Oil Stabilisation Fund	$23	1999	Oil
Kazakhstan	Kazakhstan National Fund	$58.2	2000	Oil
Algeria	Revenue Regulation Fund	$56.7	2000	Oil
UAE – Abu Dhabi	Mubadala Development Company	$48.2	2002	Oil
Palestine	Palestine Investment Fund	$0.8	2003	Non-Com*
Qatar	Qatar Investment Authority	$100	2005	Oil
UAE – Ras Al Khaimah	RAK Investment Authority	$1.2	2005	Oil
UAE – Dubai	Investment Corporation of Dubai	$70	2006	Oil
Libya	Libyan Investment Authority	$65	2006	Oil
Bahrain	Mumtalakat Holding Company	$9.1	2006	Non-Com
Oman	Oman Investment Fund	n/a	2006	Oil
UAE – Federal	Emirates Investment Authority	n/a	2007	Oil
Saudi Arabia	Public Investment Fund	$5.3	2008	Oil
UAE – Abu Dhabi	Abu Dhabi Investment Council	n/a	2007	Oil

*Non-Com = Non-Commodity (wealth derived from financial assets etc)

Foreign SWF investment in the UK

Foreign SWFs have made major investments in the UK economy. Over the last couple of years, the China Investment Corporation and the Abu Dhabi Investment Authority have both taken stakes in Thames Water. Recently South Korea's National Pension Service, already a part-owner of Gatwick Airport, set up a London office to coordinate new investments. In 2012 the former Commercial Secretary to the Treasury Lord Sassoon reported a "huge appetite" for British infrastructure amongst SWFs in the Gulf, which is reassuring: the UK needs some £500 billion of transport, energy and ICT investment in this decade alone. Given that the government is strapped for cash, it makes sense to consider harnessing some of the $10 trillion or so of capital sitting in foreign SWFs. What makes such foreign, state-owned investment vehicles attractive is that they value long-term stability; they exist to smooth out the growth paths of their own nations, which – through natural resources or export success – want to reduce their dependence on finite drivers of economic growth.

There is, however, a strong case for caution. Despite a voluntary code of conduct (the 2008 Santiago Principles), SWFs are often extremely secretive; some have a higher risk appetite than their "stabilisation" remit might suggest; above all, they are *political* beasts.

Britain's infrastructure is of strategic importance: a public good. Do we want to hitch our roads, broadband, electricity and so forth to the economic stability of the autocratic Wild East? The Arab Spring has shown the speed at which entire systems can be overthrown. Many questions surround the government's confident assertion that the SWFs can fill the gap.

British opportunities for a Sovereign Wealth Enterprise

Sovereign Wealth Funds are clearly an attractive enterprise that begs the question: why has Britain never pursued such an investment opportunity? SWFs and public pension reserve funds (PPRF) have been effectively used for nearly 10 years in most of Europe, North America and Southeast Asia. Governments (such as those in Norway, the UAE, Russia, Canada and China) use these vehicles to manage directly or indirectly large asset pools to achieve long-term national objectives.

In the 1980s North Sea oil and gas produced around £35m of licence fee revenues every day. Clearly, there was an abundance of potential income for a sustainable fund, but the idea to protect North Sea oil revenues for investment was rejected. Instead the revenues were allocated to tax cuts and welfare payments.[22] Britain could have had one of the world's biggest sovereign wealth funds had the windfall from North Sea oil been saved rather than used to cut taxes and boost spending. A study by PricewaterhouseCoopers found that the UK could have built up a nest egg of £450bn – bigger than those of Kuwait, Qatar and Russia combined – had it put tax receipts from oil and gas fields into a long-term fund. Instead, the report said, successive governments used the proceeds from oil and gas fields to keep public borrowing down rather than build up a fighting fund to tackle long-term problems such as the ageing of the population.

Now with the national debt standing at more than £1 trillion, this hardly seems like the right moment to consider putting money aside for a SWF.

But let's look a little closer. Many foreign SWFs clearly deem Britain's infrastructure an opportunity to turn a short-term revenue stream (be it from commodities, exports or other sources) into a long-term one. Do we really have no equivalent of their capital to do the same? The imminent sale of Britain's part-nationalised banks could provide just such an opportunity, or the sale of the 4G broadband spectrum. There may yet be windfall profits from oil and gas discoveries in the North Sea, or the exploitation of shale gas.

Any one of these could be used to create a British SWF. Its mission could be specifically tasked in a way that unambiguously serves the national interest, such as financing and extending the government's £250 billion National Infrastructure Plan.

The creation of further SWFs would be a tangible way for governments to show that they care about future generations by the way they manage their resources and revenues. Most parents wish to give their children and grandchildren a life better than their own. However, when countries act collectively, via government, they often uncompromisingly pursue the interests of older generations or current generations at the expense of younger or future generations – a complete reversal of the individual sentiments of its citizens. The existence of more SWFs, which promote and nurture intergenerational concerns both ideologically and pragmatically, could help to institutionalise and foster a longer-term perspective in the political sphere more generally.

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