The Challenges of Setting Up a SWF: Why, How & How Large?

Government's appetite, OSF failure and establishment of NDFI

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Sovereign Investment Workshop
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Answering the questions by case of Iran?

Why? Fluctuations, future generations and etc.

How? A Managed account, Through central bank, or a Fund

How large? Small, medium or large
Iran’s oil revenue and economic growth
Is there a sign of Dutch disease & resource curse

- Over $1.2 Trillion income
- No stable inflow of income
- Onward 2000, annual revenue is over $20 billion

Source: OPEC, ASB, 2014
Iran’s oil revenue and economic growth
Is there a sign of Dutch Disease & resource curse

Share of oil revenues in government budget

High Volatility

Rial income = exchange rate * Dollar revenue

Set by government

Tax  Oil revenue
Economic growth, Inflation, Exchange rate: Is there a sign of Dutch Disease & Resource Curse?

Inflation rate in Iran

Average: 14%
Economic growth, Inflation, Exchange rate: Is there a sign of Dutch Disease & Resource Curse?

Depreciation of Iranian Rial vis-à-vis US dollar

Source: www.energyseec.com
Iran’s real economic growth (1960-2012)

-30.0
-20.0
-10.0
0.0
10.0
20.0
30.0

-30.0
-20.0
-10.0
0.0
10.0
20.0
30.0


Political tensions
Oil revenue abundance
Sanction

Economic growth, Inflation, Exchange rate: Is there a sign of Dutch Disease & Resource Curse?

-7%
Resource Curse or Blessing?

- It is a curse if it is mismanaged: Witnessing of economic fluctuations, high inflation, unstable exchange market etc. like the Persian disease
- It is a blessing if it channelized correctly into the economy

“The Curse of Oil: The Paradox of Plenty,” The Economist, December 20, 2005

An unusual meeting took place in October at St Matthew’s church in Baltimore. After the sermon, somebody stayed behind to hear two others from Africa explain the harm that America’s gasoline guzzling does to the poor in faraway lands. An elderly parishioner raised his hand: “I know Africa is very rich in diamonds, gold, and oil, but the people are very poor. Why are your governments so bad at managing that wealth?” Austin Onuoha, a human-rights activist from Nigeria, smiled and conceded, “You hit the nail right on the head.”

It is all about “wealth Management”? So how to do it?
Saving vs. Stabilization Funds

The rationale behind a saving Fund:
- Oil and gas resources are exhaustible
- Oil wealth (not revenues) needs to be converted to financial wealth
- Preserving the share of future generation
- Sustainable development and economic stability

The rationale behind a stabilization Fund:
- Volatility in oil and gas prices and pertinent revenues
OSF as the first step for independence from oil and gas revenue was established in 2000

**Objectives**

- Stabilize government's annual budget
- Provide financial means to commercial banks for lending to private and cooperative entities for certain investment projects

Why?
Oil Stabilization Fund (OSF):

OSF Inflow and outflow of funds

Money left Promptly
Oil Stabilization Fund (OSF):

Distribution of OSF outflow

Government Expenditure

- inflow
- outflow to State budget
- Outflow to private sector
Due to Failure of OSF, National Development Fund of Iran was established in 2011

Major differences between OSF and NDFI:

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<th>Cash Inflow</th>
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<td>Managed Account with CBI</td>
<td>Financing projects and covering the government’s budget deficits</td>
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<td>Oil revenue surpluses</td>
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<td><strong>NDFI</strong></td>
<td>Established by Constitution</td>
<td>Financing domestic projects and investment in international financial markets</td>
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<td>Fixed portion of oil revenue</td>
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How Large: Distribution of oil revenues in Iran

How large:
- How much **excess revenue** is really available?
- What is the level of **domestic economy absorption**? (e.g. Norway and Kuwait)
- What pace of long term and **stable economic growth** is deemed?

Government Budget 54.5%

NDFI (minimum 20%) now %29+2%= 31%

National Iranian oil Company 14.5%

Revenues generated form export of oil, gas and condensate
32% cut from the government budget is a big cut.

A wise method to make independency from oil-based economy is a gradual departure.

A huge amount of asset under management of NDFI would lead government to find ways and means to grab a portion of the funds.

The big challenge is prevention of government in reaching NDFI resources.
NDFI Objectives

• Reduce dependency on oil & gas revenues
• Transfer a portion of oil and gas export revenues to wealth then to productive investments
• Save the future generation’s share of hydrocarbon resources
• Economic stability and sustainable development
NDFI’s Steering Boards

Board of Trustees,
headed by the president, consists of representatives of Administration, Legislative, Central Bank and Private sector,

Board of Executive Directors
consists of 5 lucid, experienced and renowned persons to run NDFI.

Supervisory Board
consists of the heads of State Audit Organization, State inspectorate organization and Supreme Audit Court.

Transparency
Efficiency
Accountability
NDFI Main Stream of Activities

Domestic
- Domestic currency loan
  (Preferred interest rates for specific sectors)
- Hard currency loans for all sectors and regions

International
- Financial assets in international markets

Developmental role & return on capital

Return on Capital
NDFI Loan Entitlement

- NDFI defines the priority for investments
- NDFI agent banks: due diligences and feasibility studies, taking the project risks
- Entitlement to receive a loan?
  
  Any non governmental entities (Companies with share of State ownership less than 20%) and foreign investors who provide 50% of the investment needs
Hard Currency Allocation by Economic Sectors

As of September 2013

- Oil & Gas: 60%
- Industry & Mines: 32%
- Construction: 2%
- Services Export: 1%
- Transport: 3%
- Agri & Water: 1%
- Others: 1%
Concluding Remarks

Why establishing a SWF:

Objectives: Multi purposes including saving, stabilization, steady economic growth, avoiding overheating etc.

Challenges: Proper establishment, good governance, design and compliance to rules and regulations

OSF Failure: lack of good structure, governance and compliance

How to establish a SWF:

Structure: Constitution with clear Article of Association, management mandates, and guarantee of good governance

Challenges: regular changes in AOA due to political motivations

NDFI: is under annual government’s budget pressure for allocation

How Large: it should consider the capacity of the pertinent economy. A very large inception leads to lack of compliance. It should be very well balanced with the facts and figures of the relevant economy.
Thank you very much for your kind attention

You are all cordially invited to the second NDFI International Conference (NIC 2015) To be held in Tehran in 2015

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