



Zimbabwe Economic  
Policy Analysis and  
Research Unit

# POLICY RESEARCH ON GLOBAL BEST-PRACTICE IN ESTABLISHING AND MANAGING A SOVEREIGN WEALTH FUND IN ZIMBABABWE



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## ACRONYMS

AfDB	African Development Bank
ANNI	Adjusted Net National Income
BOP	Balance of Payments
DRC	Democratic Republic of Congo
EITI	Extractive Industries Transparency Initiative
EMA	Environmental Management Agency
GAPP	Generally Accepted Principles and Practices
GDP	Gross Domestic Product
GDS	Gross Domestic Savings
GIC	Government of Singapore Corporation
IFSWF	International Forum of Sovereign Wealth Funds
IMF	International Monetary Fund
IWG	International Working Group of Sovereign Wealth Funds
KIA	Kuwait Investment Authority
MMCZ	Minerals Marketing Corporation of Zimbabwe
MoF	Ministry of Finance and Economic Development
NNI	Net National Income
NNS	Net National Savings
OECD	Organisation for Economic Cooperation and Development
RBZ	Reserve Bank of Zimbabwe
SADC	Southern African Development Community
SWF	Sovereign Wealth Fund
US	United States
ZAMCO	Zimbabwe Asset Management Company
ZEPARU	Zimbabwe Economic Policy Analysis and Research Unit
ZIMASSET	Zimbabwe Agenda for Sustainable Socio-Economic Transformation
ZIMRA	Zimbabwe Revenue Authority
ZIMSTAT	Zimbabwe National Statistics Agency
ZMDC	Zimbabwe Mining Development Corporation

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## FOREWORD

Minerals, like other non-renewable natural resources, provide a window of opportunity for the development of a country, but can also present enormous challenges to manage. Their exploitation generates employment, infrastructure development, foreign currency, contributes to the fiscus, and provides inputs to other industries, among other benefits. However, minerals are exhaustible and mineral prices are volatile. In addition, mineral exploitation requires huge capital outlay which is often not available locally. As a result, the net benefits of mineral resources are not obvious, but predicated on proper management of mineral wealth which entails, among other things, instituting strong governance institutions, enhancing public investment management capacity, creating a favourable business environment to attract foreign capital, effective management of resource rents when the minerals are still available, implementing sound and prudent macroeconomic policies, and enhancing contract negotiation skills.

Since mineral resources are finite and mineral prices are volatile, policy makers in mineral rich countries are faced with a number of key policy issues which include: (a) how to sustain a stable economic growth path in the face of exhaustible mineral resources and volatile mineral prices; (b) how to ensure intergenerational equity in the distribution of expenditures financed from mineral wealth; (c) how much to save and invest from the revenues realised from mineral resources; (d) where to invest savings from mineral resources – domestic or foreign economy; (e) what fiscal rules and macroeconomic policies are suitable in a mineral rich country to safeguard against the impact of mineral price volatility; and (f) what precautionary savings could be made taking advantage of the exhaustible mineral resource and mineral price volatility.

This study explored the best practices in the establishment and management of Sovereign Wealth Funds (SWF) noted some key policy and legislative issues that deserve Government's attention. The Zimbabwean Government enacted SWF Zimbabwe Act in 2014 and subsequently set up a SWF in 2015 and is progressing towards the operationalisation of the SWF. Therefore, the study comes at an opportune time where its findings will inform the implementation of this key initiative. The study drew lessons from other country experiences and best international practice as espoused in the Santiago Principles. It is my hope that

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the study's policy recommendations will inform and provide guidance in the operationalisation and management of the SWF.

In conclusion, I want to express the Ministry's gratitude to the African Development Bank (AfDB) that provided funding that made this study possible and to the ZEPARU research team that carried out this study. I also extend my heartfelt gratitude to stakeholders in the minerals sector who participated and provided valuable information during the course of this study. In this regard, I commend this very important study to all the stakeholders and I remain confident that all will join hands in the implementation of the recommendations in this study.

A handwritten signature in black ink, appearing to read 'W. K. Chidakwa', written in a cursive style.

HON. W. K. CHIDAKWA (MP)

MINISTER OF MINES AND MINING DEVELOPMENT

# EXECUTIVE SUMMARY

ZEPARU undertook this study as a follow up to its 2012 Mining Sector Policy Study which recommended the establishment of Sovereign Wealth Funds (SWFs). In this regard, the current research paper reviewed country experiences in establishing and managing SWFs to identify best and replicable practices that could inform initiatives to establish a SWF in Zimbabwe. The Government of Zimbabwe made a policy decision to establish a SWF in spite of the prevailing economic challenges. In particular, the country's economic plan, the Zimbabwe Agenda for Sustainable Socio-Economic Transformation (ZIMASSET, p.48) notes that "The creation of a Sovereign Wealth Fund will be given priority under this Plan to backstop and provide predictability and sustainability to Government innovation". Thus, the findings of this research paper provide useful insights that will enhance the implementation of the policy decision to establish a SWF. Furthermore, this study provides insights on other country experiences in managing SWF to the new Board and management of the SWF in Zimbabwe.

The study provides recommendations in four key areas: (1) strengthening macroeconomic fundamentals; (2) addressing shortcomings in the current SWF Act, (3) capacity building to manage natural resources and the SWF, and (4) long-term policy considerations.

## STRENGTHENING MACROECONOMIC FUNDAMENTALS

When government made a policy decision to establish a SWF it was conscious that the macroeconomic context prevailing in the country was different to that obtaining in other countries that had established SWFs. Some countries established SWFs at a time when they had balance of (BOP) payments and fiscal surpluses. The initial conditions under which Zimbabwe is setting-up the SWF are characterised by high debt over-hang; binding fiscal space constraints and balance of payments deficit. The country experiences reviewed in this study have also shown that not all countries that established SWFs had BOP and fiscal surpluses. Some have argued that the decision to establish SWFs shows government's commitment to break with the past and induce a culture of saving and fiscal discipline. In this regard as the country proceeds with the setting up of the SWF, concurrent measures need to be put in place to address macroeconomic fundamentals that underpin the successful establishment of SWFs.

Cognisant that the SWF is not a substitute for building up international reserves, the Reserve Bank of Zimbabwe should continue to work on boosting international



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reserves to at least 3-months import cover. Country experiences have shown that the main objective of SWF is building savings for future generations. Generally, funds from SWF are not as readily accessible as usable international reserves to meet immediate balance of payments needs.

It has also been observed by some stakeholders that with the current fiscal space challenges it may not be feasible to meet the 25% of royalties outlined in the SWF Act. The initial amounts from the fiscus maybe small but what is important is establishing the principle and the institutional framework that will make it easy to scale up as conditions improve. Zimbabwe has already adopted debt and arrears clearance strategy and the proposed comprehensive reforms which if successfully implemented should reduce debt to sustainable levels and provide relief on the binding fiscal constraints. However, such a strategy is only viable when:

- returns on the SWF are higher than the interest rate being charged on the sovereign debt;
- the government does not renege on its commitments set out in the Zimbabwe Debt and Arrears Clearance Strategy. The viability of this strategy can be bolstered through implementation of deeper reforms anchored on the achievements of the IMF staff monitored programme and
- the Board explores innovative funding strategies to nurture the growth of the SWF.

Leveraging on the abundant mineral resources to build a SWF requires Government to put in place policies and programmes to boost value added mineral exports; and improve transparency and accountability in the management of natural resources revenues. This can be achieved by formulating enforceable fiscal rules that ensure that some resource revenues are saved in a SWF rather than used to meet current consumption. The SWF helps to transform exhaustible resources into financial assets or growth enhancing infrastructural assets that support the economic transformation of the country.

The Government should adopt economic measures of performance other than GDP or GNI that take into account depletion of natural resources, namely: the adjusted net income measure, the adjusted net savings measure and the adjusted net operating balance metric. The current accounting system that the Government follows treats the depletion of natural resources as volume change rather than as capital consumption. As a result the depletion of natural resources

has no impact on the measured operating balance for government operations. Implementation of these economic measures of performance may require deliberate programmes to build and sustain capacity which can be developed with technical assistance from development partners.

The Government should streamline the levels of mining fees and charges to levels that promote the competitiveness of the sector and harmonise systems of agencies that collect mineral revenues. High fees and charges that are not comparable to the country's regional counterparts increase the cost of investment, impede new investments and sterilise mining ground. Government needs to expedite the development of a new mining fiscal regime that seeks to enhance the contribution of the mining sector by ensuring accountability and transparency on the part of government and mining companies. The mining fiscal regime also needs to balance the various fees and taxes being paid by the mining sector and the operational viability of players in the sector while at the same time encouraging new investment in the sector.

## STRENGTHENING THE SWF ACT

The SWF of Zimbabwe Act lays out legal, governance and institutional arrangements which are generally consistent with the General Accepted Principles and Practices (GAPP) better known as the Santiago Principles governing SWFs. The Santiago Principles are a voluntary framework of investment and operational principles and practices. They emphasise appropriate governance, accountability arrangements and prudent, commercial investment activity. They also provide guidance to countries establishing, or considering establishing a SWF. The SWF Act explicitly subscribes to the Santiago Principles by restating them in the Third Schedule of the Act. However, this study noted a few areas in the Act that may need to be reconsidered and suggested ways to address the areas identified as needing improvement with a view to strengthen the Act and enhance its implementation. These include:

- (a) The Act should be easily accessible to the public in accordance with Section 16 of GAPP for public disclosure.
- (b) The discretionary powers given to the Minister to give direction to the Board can be viewed within the context of GAPP as interfering with the operational independence of the Board.
- (c) There should be specific mention of what exactly can be withdrawn – i.e. is it from the Fund's capital or withdrawals are strictly restricted to interest

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accruing to investments made by the Fund's management. The Act should also provide a rule on how much can be withdrawn from the SWF for purposes of closing a budget deficit. Good practice requires withdrawal rules to be closely linked to the government budget surplus/deficit, and the amount to be determined as part of the annual budget process or pre-agreed rules.

- (d) The Act should explicitly provide for the establishment of a Future Generations Fund among the segregated accounts of the Fund mentioned in Section 15.
- (e) The Act should provide criteria for allocating resources among the segregated accounts of the Fund.
- (f) The specific types of assets that the Fund should invest in should be decided by the Board and embodied in the Investment Policy. This would allow flexibility required for the investment strategy to respond to changes in market conditions to meet the objectives of the SWF.

## ADDRESSING CAPACITY TO MANAGE RESOURCES AND THE SWF

The SWF is a new institution in Zimbabwe and inevitably there may not be adequate human capital with the capacity and experience in managing it. In this regard Government with support of development partners like the AfDB should undertake a capacity building programme for the SWF staff.

Furthermore, the Government at an appropriate time can consider joining the IFSWF to benefit from its body of knowledge and sharing experience with other member countries in managing SWFs.

## LONG-TERM POLICY CONSIDERATIONS

Finally, cognisant of the exhaustibility of natural resources, in the long run, the Government should ensure that factors generally accepted as sources of growth are in place. These include the following, among others:

- Stability-oriented and competitiveness enhancing economic policies;
- Flexible and competitive product and labour markets;
- Increasing valued added manufactured exports and promoting a high degree of exposure to foreign trade;
- Having the requisite infrastructure and technology to support higher investment and economic growth rates; and
- Enhancing productivity in all the productive sectors of the economy.

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# SECTION I: INTRODUCTION AND BACKGROUND

Zimbabwe has a diverse and well-developed mineral sector with more than 40 different minerals. The recovery of the minerals sector can unleash immense potential to anchor inclusive economic growth and development in Zimbabwe. For example, the successful implementation of the Zimbabwe Agenda for Sustainable Economic Transformation (ZIMASSET), largely depends on the judicious exploitation of mineral resources. The mining sector used to be supported by exceptional physical and technological infrastructure, some of which needs to be rehabilitated and upgraded. The main constraints of the sector include: (a) weak institutional and governance to manage and leverage on the country's rich mineral wealth; (b) lack of updated mineral policy and legal framework; and (c) weak institutional capacity for geological survey and mineral exploration.

In an effort to address these constraints, the Government has prepared a draft Minerals Policy and plans to: (a) amend the Mines and Minerals Act; (b) adopt and implement the Extractive Industries Transparency Initiative (EITI); (c) adopt a natural resource charter; and (d) establish a sovereign wealth fund (SWF) to manage natural resource rents such as royalties in order to finance development programmes.

In 2012, ZEPARU conducted the Mining Sector Policy Study which recommended the establishment of SWFs for Zimbabwe. Specifically, the study proposed the following funds:

- 1) Long-term Human and Physical Infrastructure Fund: The fiscus would draw from this fund for investment into long-term physical infrastructure (road, rail, power, and telecommunications) projects and human resources development.
- 2) Minerals Development Fund: This fund could finance the massive investment required for geological survey to acquire a better understanding of the geology and to uncover new exploration targets. It could also fund the development of targets for tender or development by the state (or sub-contractors), the development of a national minerals technology capacity in partnership with the private sector, and investments into the backward and forward mineral linkages industries in partnership with the private sector.

- 3) **Fiscal Stabilisation Fund:** A major proportion of the resource revenues could be accumulated into this fund to be drawn down by the fiscus when commodity prices fall below predetermined long-term projections, protecting the budget from revenue shocks; This fund would, over time, become a Future Fund (intergenerational equity) for the nation to draw on as mineral resources are depleted (finite endowment).

According to the International Working Group of Sovereign Wealth Funds (IWG), SWFs are special purpose investment funds or arrangements that are owned by the general government. They have diverse legal, institutional and governance structures that enable them to hold and manage assets to achieve financial objectives by employing a set of investment strategies that include investment in foreign financial assets (savings) and investment in physical and human capital (fiscal outlays). They are commonly established from balance of payment (BOP) surpluses, official foreign currency operations, the proceeds of privatisations, fiscal surpluses and receipts from commodity exports. Surveys have shown that more than two-thirds of them are established from mineral royalties.

The International Monetary Fund (IMF) broadly distinguishes 5 types of SWFs by objectives:

- Fiscal stabilisation funds set up to insulate the budget and economy from volatile commodity prices and to smooth boom/bust cycles.
- Fiscal savings funds established to share wealth across generations.
- Reserve investment corporations established as a separate entity either to reduce the negative cost-of-carry of holding reserves or to pursue investment policies with returns.
- Pension-reserve funds with identified pension and/or contingent-type liabilities on the government's balance sheet.
- Development funds that allocate resources for funding priority socio-economic projects such as infrastructure.

The Zimbabwe Economic Policy Analysis and Research Unit (ZEPARU) undertook this study for the Ministry of Mines and Mining Development, as part of the Governance and Institutional Support Project (GISP) between the Government of Zimbabwe and the African Development Bank (AfDB) which commenced in 2014. The study followed gazettement of the Sovereign Wealth Fund of Zimbabwe Act on 10 November 2014 and its operationalisation on 26 June 2015 through official notification published in the Government Gazette. The first 5 of 9 Board

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Members were appointed at the same time and came together, as a Board, on 1 July, 2015 under the Chairmanship of Dr Kombo Moyana, former Governor of the Reserve Bank of Zimbabwe (RBZ). The Act allows for the appointment of 4 additional members with the possibility of bringing in foreign representation on the Board. The inclusion of the Chief Executive Officer of the SWF of Zimbabwe as an ex officio member brings the total number of Board members to 10. The SWF is expected to provide additional funding for the implementation of priority programmes and projects under the ZIMASSET national economic blueprint.

The overall objective of this study was to identify best practice in the establishment and management of commodity SWF. Specific objectives included:

- To review other countries experiences on the establishment and management of SWFs;
- To learn from other countries good practices that Zimbabwe can adapt to manage its SWF;
- To establish from other countries bad practices that Zimbabwe should avoid in establishing and managing its own SWF;
- To inform the policy process to support the development and management of the SWF in Zimbabwe and;
- To provide actionable recommendations to policy makers and practitioners on mineral resources management using commodity SWFs.

The rest of the policy research paper is structured as follows: Section 2 provides an overview of the economy of Zimbabwe and the contribution of the mining industry. Section 3 discusses fiscal policies in natural resource countries and the rationale of SWFs firstly, in general and secondly, focusing on the case for Zimbabwe. Section 4 discusses the best practices in building the legal framework, institutional structures and governance of SWFs while Section 5 assess the readiness of Zimbabwe for the establishment of a SWF. Section 6 provides stakeholders' views on how a SWF should be established and managed. Recommendations and policy considerations for Zimbabwe are then discussed in Section 7.

# SECTION 2: OVERVIEW OF ZIMBABWE'S ECONOMY AND THE CONTRIBUTION OF THE MINING INDUSTRY

## 2.1 ECONOMY AT A GLANCE

The country's economic and development indicators show the following for the year 2014:

Gross domestic product (GDP)	US\$14.068 billion
GDP growth rate	3.8 %
Per capita income (at current prices)	US\$ 922.49
Inflation (average annual)	-0.2 %
External Government debt (% of GDP)	77 %
Current account balance (% of GDP)	-20.17 %
Usable international reserves (months of imports)	0.5
Population (millions)	15.25 million
School enrolment, primary (gross %)	109 %

Sources: Ministry of Finance and Economic Development, Reserve Bank of Zimbabwe (RBZ), Zimbabwe National Statistics Agency (ZIMSTAT) and World Bank

There are four salient statistics that have a bearing on the establishment of a SWF. First, is Zimbabwe's per capita income that places it in the low income group of countries. Second, is the high external debt level of US\$10.838 billion which translates to 77% of GDP as at December 2014<sup>1</sup>. Third, are exports that are underperforming while imports are high resulting in a widening current account balance and grossly inadequate foreign exchange reserves as reflected by the months of import cover. The two weeks of import cover as at end of December 2014, shows that the usable international reserves were below the standard threshold of at least 3-month threshold.

According to the IMF and World Bank debt sustainability analysis of 2014, external

<sup>1</sup>Ministry of Finance and Economic Development and RBZ (2015)



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debt is expected to continue to grow from 82% of GDP in 2013 to 122% in 2023 before declining to 108% in 2033. This analysis concluded that in the absence of debt relief, key economic indicators suggest unsustainable fiscal position in the medium-term and in the longer predictable 20 year horizon. However, the implementation of the Government's debt and arrears clearance strategy and the accompanying economic and legislative reforms is likely to change landscape on debt sustainability.

## 2.2 CONTRIBUTION OF THE MINING SECTOR TO THE ECONOMY

Zimbabwe's mining sector plays an important role in the economic development of the country. The sector has contributed to the economy in various forms including its direct contribution to GDP, employment creation, foreign currency generation and contribution to the fiscal revenue. The mining sector has been the main driver of economic recovery in 2010 and 2011, contributing 2.6% and 2.1% of GDP growth, respectively (Table 1), owing to the increase in global commodity prices especially for gold and platinum which increased from US\$ 973 to US\$1, 569 per ounce for gold and US\$1, 203 to US\$1, 720 per ounce for platinum during that period (World Bank Global Economic Monitor Commodities, 2015). However, the softening of gold and platinum prices on the international market from 2012 impacted negatively on the mining sector's overall contribution to GDP growth. In 2014 the sector was initially projected to grow by 11.4% but contracted by -2.1% for the first time since 2009 owing to increasing production costs, low exploration, lack of capital and the weakening of international commodity prices.

**Table 1: Mining Sector Contribution to Growth in relation to other sectors, 2010-2015.**

	2010 Act	2011 Act	2012 Act	2013 Act	2014 Est	2015 Proj	2016 Proj	2017 Proj	2018 Proj
Agriculture, hunting and fishing	0,9	0,2	0,9	-0,3	2,5	0,4	0,4	0,4	0,3
Mining and quarrying	2,6	2,1	0,8	1,1	0,0	0,2	0,3	0,5	0,5
Manufacturing	0,3	1,7	0,7	-0,1	-0,6	0,1	0,1	0,2	0,3
Electricity and water	0,7	0,2	0,0	0,2	0,2	0,0	0,1	0,2	0,4
Construction	0,2	1,1	0,6	0,1	0,1	0,1	0,1	0,1	0,1
Finance and insurance	0,6	0,6	1,8	0,9	0,2	0,3	0,4	0,4	0,4
Real estate	0,1	0,6	1,0	0,0	0,0	0,1	0,1	0,1	0,1
Distribution, hotels and restaurants	1,3	0,6	0,6	0,5	0,5	0,6	0,5	0,6	0,5
Transport and communication	0,6	0,0	0,7	0,7	0,1	0,4	0,2	0,2	0,3
Public administration	0,7	0,5	0,5	0,1	0,1	0,1	0,0	0,0	0,0
Education	1,0	2,0	1,8	0,2	0,2	0,1	0,1	0,1	0,1
Health	0,2	0,1	0,1	0,0	0,1	0,0	0,0	0,0	0,0
Domestic services	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Other services	0,6	0,5	-0,5	-0,2	0,0	0,1	0,1	0,1	0,1

Source: Ministry of Finance and Economic Development, Macroeconomic Framework, 2015

Nevertheless, the sector is expected to be among the key drivers of economic growth, contributing between 0.2% and 0.5% to GDP growth over the period 2015 to 2018 on account of government initiatives to mitigate challenges through promoting beneficiation and value addition and amendments to the Mines and Minerals Act to create a progressive and investor-friendly mining management system, which is likely to attract investment into mining.

As at the end of 2013, the manufacturing, agriculture, and transport sectors contributed more to GDP than the mining and financial sectors (Table 2). However, the contribution of the mining sector to GDP has been increasing over the years from 6.9% in 2009 to 9.8% in 2013 (Table 2). The mining sector

has also contributed 10-13% of government revenue between 2009 and 2014 (Chamber of Mines of Zimbabwe, 2014).

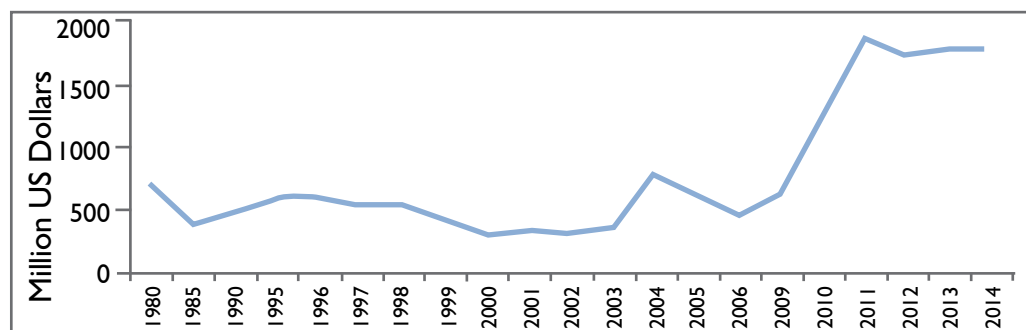
**Table 2: Percentage Contribution of Selected Sectors to GDP, 2009 - 2013**

	2009	2010	2011	2012	2013
Agriculture, Hunting, Fishing and Forestry	12.7	12.3	11.1	10.8	10.1
Manufacturing	13.1	12.0	12.2	11.6	11.0
Transport and Communication	13.2	12.5	11.1	10.7	11.0
Mining and Quarrying	6.9	8.5	9.4	9.2	9.8
Finance and Insurance	7.0	6.8	6.6	7.6	8.1

Source: ZIMSTAT

In 2014, the mining sector created more than 45,000 jobs directly and another 78 260 jobs in other industries that have linkages to the mining sector.<sup>2</sup> However, the proportion of the labour force absorbed by the mining sector is very low (2% of total labour force) owing to the capital intensive nature of the industry. The value of mining production from 1980 to 2008 averaged US\$470 million<sup>3</sup>. However, it doubled to US\$1, 241 million in 2010 from US\$621 million in 2009, and increased further to US\$1, 769 million in 2014 (Figure 1). The marked increase in the value of production is explained by the increase in commodity prices between 2009 and 2011. The value of mining production remained high thereafter.

**Figure 1: Value of Mining Production, 1980 - 2014**



Source: ZIMSTAT

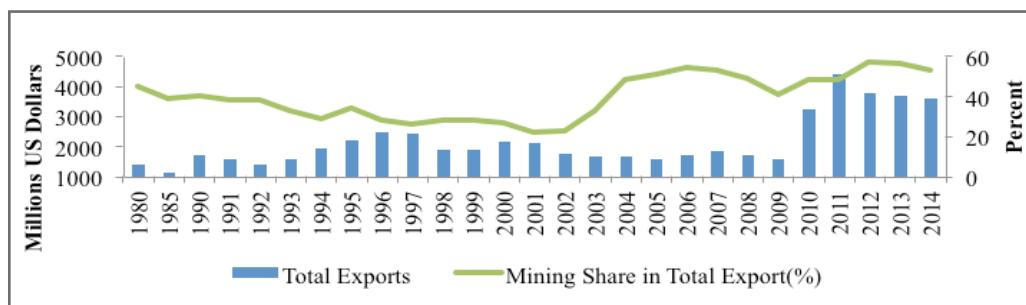
Mining sector contributes the most to foreign exchange earnings as compared

<sup>2</sup>Chamber of Mines of Zimbabwe, 2014

<sup>3</sup>Due to hyperinflation, figures for 2007 and 2008 are estimates

to other sectors. The sector's contribution has increased significantly from an average of 38% between 1980 and 2008 to an average of 50% between 2009 and 2014 (Figure 2). In 2014 alone, mineral exports contributed US\$1.905 billion, representing 53% of the country's total exports.

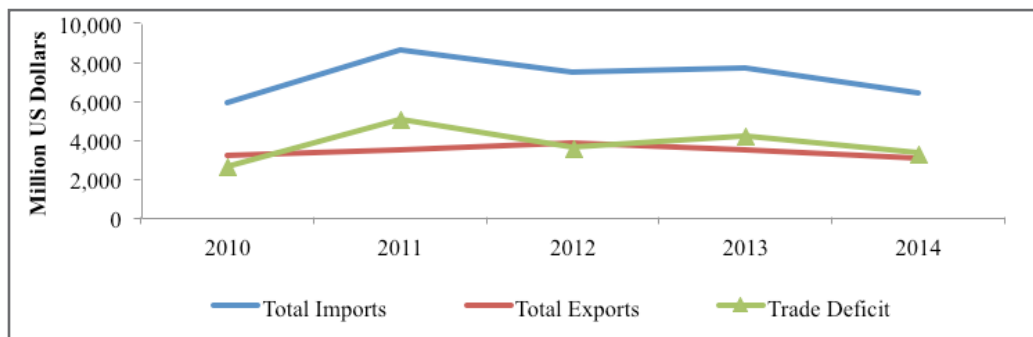
Figure 2: Total Exports and Mining Share in Total Export (%), 1980 -2014



Source: ZIMSTAT and RBZ

Zimbabwe is also faced with a high external debt burden of US\$10.838 billion which has affected its potential to unlock fresh capital and investment. The country is also faced with a large trade deficit as it imports most of its products due to deindustrialisation. In 2014, for instance, the country's merchandise imports amounted to US\$6.4 billion, which significantly surpassed merchandise exports of US\$3.1 billion, resulting in a trade deficit of US\$3.3 billion (Figure 3). Trade deficit narrowed by about 18% from US\$3.9 billion in 2013 to US\$3.3 billion in 2014. This partly reflects the positive effects emanating from decline in crude oil prices on the international market. The country's external sector position remains under considerable pressure, on the back of subdued export performance, coupled with relatively large absorption of imports. The situation is further compounded by a combination of depressed foreign direct and portfolio investment inflows and absence of balance of payment support. In addition, developments on the global economic front such as the depressed international commodity prices, notably gold and platinum coupled with the continued depreciation of the South African rand, relative to the US dollar, are also exerting further pressures on Zimbabwe's external position.

Figure 3: Zimbabwe's External Position, 2010-2014



Source: ZIMSTAT

In the absence of foreign reserve buffers, the current account has largely been financed by inflows from the diaspora and debt, creating short-term and long-term offshore lines of credit to the private sector. Hence, more needs to be done to attract investment into the manufacturing sector to boost manufactured exports that are less susceptible to international price volatility.

Zimbabwe also faces a shrinking tax base as a result of company closures. For example, in 2015 recurrent expenditure constituted about 95.6% of the total revenue generated, with the remainder earmarked for capital expenditure, which is unsustainable given the infrastructural requirements of the country<sup>4</sup>. A large chunk of recurrent expenditure was consumed by employment costs which constituted about 59.8% of recurrent expenditure.

Like other sectors of the economy, the mining sector is affected by high employment costs, poor infrastructure, skills shortages and liquidity challenges. Employment costs are high in Zimbabwe, having an average minimum wage of US\$246.50 per month, which is between 42% and 53% higher than the minimum wage in Botswana, Mozambique and Zambia (ZEPARU, 2014). Nevertheless, the Zimbabwean minimum wage for an entry level position is roughly 38% of the South African levels, where the comparable minimum is US\$646.40.

Additionally, in Zimbabwe the Poverty Datum Line (PDL) is normally used as a reference for wage negotiations as opposed to productivity levels and ability of firms to pay salaries, especially in times of difficulties. In the circumstance where companies need to re-tool and retrench at the same time the practice of

<sup>4</sup>Percentages calculated from data from Ministry of Finance and Economic Development, 2015

retrenching implicitly becomes part of the recapitalisation costs. Hence labour in Zimbabwe is a fixed cost and not a variable cost (ZEPARU, 2014). However, the Supreme Court ruling in July 2015 allowed retrenchment of employees on three months' notice. This move by the Government gave companies some flexibility to adjust its workforce in order to meet the company's requirements.

The mining sector is faced with a number of taxes which currently constitute 17% of the mining sector profitability and around 60% in mining sector profitability before tax<sup>5</sup>. Zimbabwe's mineral royalties are the highest when compared to those of other countries in the region (Table 3). Such a taxation regime weighs down the maximum output the sector can generate.

**Table 3: Royalty rates in selected Southern African Development Community (SADC) countries**

Zimbabwe	1% - 15%	Diamonds - 15%, Platinum and Precious stones - 10 %, Gold – Primary producers' basic rate is 5%, reduced to 3% on incremental output of gold using the previous year's production as a base year, with effect from 1 <sup>st</sup> January, 2016 and 1% for small scale miners. Other Precious metals - 4% Base metals and Industrial minerals - 2% Coal - 1%
Angola	2% - 5%	Stones and precious metals - 5% (semi-precious stones - 4%) Metallic minerals - 3% Others minerals - 2%
Botswana	3% - 10%	Precious stones - 10% Semi-precious -5% Other -3%
Mozambique	3% - 10%	10% on diamonds and precious metals (Au, Ag, Pt) and precious stones 6% on semiprecious stones 5% on basic minerals 3% on coal and other mining products
Namibia	4% - 5%	Precious metals - 5% Base and rare metals - 5%, Semi-precious stones - 4%, Industrial minerals - 4%.
Tanzania	2%- 12.5%	A 3% royalty is charged on gold and all other minerals 5% on diamond 12.5% for petroleum and gas
Zambia	3%-5%	Precious metals and stones -5% Base Metals – 3%

Source: Jourdan et al, 2012 and 2016 National Budget Statement

<sup>5</sup>Chamber of Mines

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The fact that mineral resources are finite provides the rationale behind government capturing extra rents whilst the mineral is still extant. Zimbabwe's mineral fiscal regime has been failing to provide a balance between maximizing state revenues and encouraging investment in new exploration and mining. The current fiscal regime tends to add more to operating costs through relatively high royalties, fees and levies. Several government agencies, including local authorities are involved in the collection of mineral revenue and these include Zimbabwe Revenue Authority (ZIMRA), Environmental Management Agency (EMA), Ministry of Mines and Mining Development, Zimbabwe Mining Development Corporation (ZMDC) and Minerals Marketing Corporation of Zimbabwe (MMCZ). This has raised concern that the various uncoordinated collections not only compromise viability of the mining sector, but also present transparency and accountability challenges over mineral revenues accruing to the country. In an effort to redress these challenges, Government is in the process of reviewing the mining fiscal regime to ensure that the country maximises the benefits from its mineral resources, while at the same time encouraging investment in the sector.

## 2.3 MINERAL SHARES AND CONTRIBUTION TO THE FISCUS

The data on percentage shares in total value of minerals (Table 4) shows that on average over the period 2009 – 2013 gold contributed more than other sectors at 25.5%, followed by platinum 24.1% and diamonds 17.8%. On the other hand, nickel contributed 6.7% which is more than the contribution by palladium (6.6%), chrome (6.4%) and coal (5.7%).

**Table 4: Mineral Percentage Shares in Total Value of Mineral Production (US\$), 2009 - 2013**

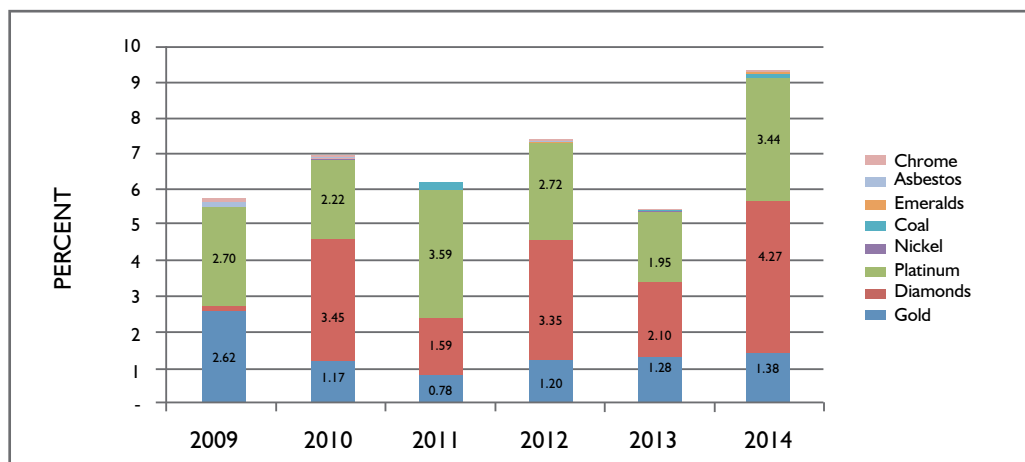
	2009	2010	2011	2012	2013
<b>Diamonds\cts</b>	3.0	19.7	19.1	25.6	21.4
<b>Gold \kg</b>	22.7	22.1	26.4	31.1	24.9
<b>Platinum \kg</b>	34.5	23.8	21.6	18.5	22.1
<b>Paladium \kg</b>	6.0	5.8	7.2	5.9	8.2
<b>Nickel \t</b>	9.0	6.5	7.0	4.5	6.3
<b>High Carbon Ferrochrome \t</b>	7.3	7.8	6.3	5.5	5.1
<b>Coal \t</b>	8.4	5.6	4.2	3.3	6.8
<b>Chrome \t</b>	2.7	3.3	2.9	1.9	1.4
<b>Rhodium \kg</b>	3.5	2.9	2.1	1.2	1.3
<b>Copper \t</b>	2.2	1.7	2.0	1.6	1.8
<b>Iridium \t</b>	0.2	0.2	0.3	0.4	0.3
<b>Graphite \t</b>	0.1	0.0	0.2	0.2	0.1
<b>Cobalt \t</b>	0.1	0.0	0.2	0.1	0.1
<b>Phosphate \t</b>	0.0	0.3	0.2	0.1	0.0
<b>Ruthenium \kg</b>	0.1	0.1	0.1	0.1	0.1
<b>Asbestos \t</b>	0.2	0.1	0.0	0.0	0.0
<b>Iron Pyrite \t</b>	0.0	0.0	0.0	0.0	0.0
<b>Ferrosilicon \t</b>	0.1	0.0	0.0	0.0	0.0
<b>Magnesite \t</b>	0.0	0.0	0.0	0.0	0.0
<b>Iron Ore \t</b>	0.0	0.0	0.0	0.0	0.0
<b>Total</b>	100.0	100.0	100.0	100.0	100.0
<b>Total Mineral Revenue(US\$)</b>	692,020,718.4	1,721,757,425.8	2,489,293,207.3	2,517,062,036.1	2,512,278,565.5

Source: Chamber of Mines Zimbabwe and Kimberly Process Certification Scheme

Over the period 2009-2014, the contribution of the mining sector to the fiscus has been oscillating between 5% and 9.5% of total tax revenue, with the largest contribution of 9.3% in 2014 (Figure 4). In 2009 the contribution to the fiscus was 5.7% and it rose to 6.95% in 2010 before dropping to 6.1% in 2011. The contribution then rose to 7.39% in 2012 and dropped to 5.42% in 2013 before increasing phenomenally to 9.34%. Platinum, diamonds and gold are by far the largest contributors to the share of mineral tax revenue in total tax revenue (Figure 4).



Figure 4: Percentage contribution to total tax revenue by mineral, 2009-2014



Source: Ministry of Finance

## 2.4 UNDERSTANDING THE WEALTH OF NATIONS

According to the World Bank (2006), 58% of global wealth (excluding oil exporters) is in the form of intangible capital defined as human capital and the quality of formal and informal institutions. Produced assets (or produced capital) account for 16% and the balance of 26% is natural capital or natural resources. The 2000 estimate of natural capital in Zimbabwe was pegged at US\$1,531 per head of the population accounting for 16% of total wealth and the share of produced capital was put at 14% while intangible capital accounted for 70%. The World Bank also estimated that subsoil assets (mineral wealth) accounted for 20% of natural capital, cropland's share was 23%, and pasture 17%, non-timber forest resources and timber 36% and protected areas accounted for the remaining balance of 4%.

It is noteworthy that although Zimbabwe cannot strictly be classified as a mineral rich country like South Africa, Botswana, Democratic Republic of Congo (DRC), Ghana or Zambia, its share of 20% of subsoil assets in natural capital is relatively high. As shown in Table 5, Hawkins (2009) observes that its mineral wealth while insignificant relative to South Africa, is substantially greater than that of designated mineral rich countries like Botswana and Zambia.

**Table 5: Wealth Estimates for Selected Sub-Saharan Countries, 2000**

Country	Natural wealth %	(of which) Subsoil assets %	Produced capital %	Intangible capital %	Total wealth US\$ billions	Mineral wealth US\$ billions
Botswana	7.8	0.6	22.0	70.2	67.9	0.40
Ghana	12.9	0.6	6.6	80.5	196.0	1.10
Namibia	6.4	0.1	15.1	78.5	69.9	0.07
South Africa	5.7	1.9	12.2	82.1	2,623.7	49.90
Zambia	27.1	2.0	10.6	62.3	64.9	1.28
Zimbabwe	15.9	3.1	14.3	69.8	121.6	3.77

Source: World Bank (2006): *Where is the Wealth of Nations?*

Notwithstanding the relatively high mineral wealth by Sub-Saharan standards, Hawkins (2009) further observes that Zimbabwe is somewhat less wealthy with per capita wealth of less than one-quarter of that in Botswana and only 16% of that in South Africa and lower than in resource-poor countries like Lesotho and Swaziland (see Table 6).

**Table 6: Wealth per Capita in US\$ in 2000: Zimbabwe and Comparative Countries**

Country	Wealth per head	Country	Wealth per head
Mauritius	60,284	Ghana	10,635
South Africa	59,629	Zimbabwe	9,612
Botswana	40,592	Kenya	6,609
Namibia	36,907	Zambia	6,654
Swaziland	27,738	Malawi	5,200
Lesotho	15,477	Mozambique	4,232

Source: Hawkins (2009) quoting from World Bank (2006): *Where is the Wealth of Nations?*

## 2.5 RESOURCE MANAGEMENT

It is not the possession of resources that matters but their management as evidenced by Botswana whose sound management translated into the best long-run growth track record in Sub-Saharan Africa (see Table 7 of selected SADC

countries). Mismanagement in DRC and Zambia, for instance, had negative socio-economic consequences. Table 7 also contrasts strong productivity growth in Botswana with negative contributions of total factor productivity in DRC, Zambia and Zimbabwe, again illustrating that resources are not a curse per se but their mismanagement of these resources is.

Table 7: Sources of growth 1960-2008 (% p.a.) for selected SADC Countries

Country	GDP growth	Physical capital	Labour	Total factor productivity
Botswana	7.5	3.8	1.7	2.0
DRC	0.2	1.1	1.6	-2.4
South Africa	3.1	1.5	1.4	0.1
Zambia	2.3	1.7	1.6	-1.0
Zimbabwe	2.6	1.6	1.8	-0.7

Source: Hawkins (2009) quoting from World Bank (2006): *Where is the Wealth of Nations?*

## SECTION 3: FISCAL POLICIES AND THE RATIONALE OF SWFS

Natural resources have been observed to pose significant policy challenges in the formulation and implementation of fiscal policies in resource-producing countries. There are several reasons for this.

First, the prices of natural resources are very volatile and uncertain. This has the effect of complicating fiscal management, budget planning, and the efficient use of public resources. For instance, it has been observed that fiscal policies in natural resource producing countries are pro-cyclical during commodity price booms (York and Zhan, 2009).

Second, natural resources are exhaustible and run the risk of obsolescence raising complex issues of intertemporal welfare, long-term fiscal sustainability and asset management. With regard to intertemporal welfare, consideration has to be made on how to allocate resource wealth to the current and future generations, i.e., how much to consume today and how much to save based on the fact that natural resources belong to all generations. Traditional analyses of fiscal sustainability are based on medium-term projections of the public debt-to-GDP ratio given certain macroeconomic projections and fiscal policy assumptions. However, for natural resource-producing countries, the analysis should also consider exhaustibility of resources and hence the projection period should be extended significantly beyond the typical horizon utilised in traditional sustainability analyses. In a natural resource-producing country the main indicator of the fiscal position for sustainability analyses is the non-resource primary balance, e.g. that recurrent expenditure should be financed by current tax revenue. However, the estimation of wealth from future resource revenues is subject to uncertainty due to fluctuating commodity prices, interest rates and costs, and uncertainty of the size of resource reserves.

Third, natural resource revenues largely originate from abroad so that the fiscal use of these resources can have significant impact on the domestic economy. They can be a source of the Dutch Disease, i.e., the over-valuation of the exchange rate that undermines the competitiveness of non-resource sectors and diversification of the economy.

Fourth, the exploitation of natural resources can give rise to sizeable rents that have the potential to encourage rent-seeking and corruption by public officials and business leaders. It can also increase the risk of civil unrest as rival groups

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squabble over mineral or oil deposits.

These characteristics of natural resources impact on public finances and government development policy. Exhaustibility has implications for both how economic performance is measured and how a government leverages natural resources for development. Two critical questions for economic management arise:

- How should we measure economic performance?
- How should we design fiscal policies to sustain growth and development in the face of exhaustibility?

GDP growth might not be an appropriate measure of economic performance for economies that depend on exhaustible resources, especially small developing economies for two reasons:

- 1) National income rather than domestic product might be a more appropriate measure in countries where largely foreign-owned extractive industries are substantial so that payments to foreign-owned factors are substantial.
- 2) National income must be adjusted by offsetting a part of the credits for resource extraction with the corresponding depletion costs similar to capital depreciation.

When measuring economic performance two national accounting measures are needed for resource-extracting economies, namely: adjusted net national income and adjusted net savings. Hamilton and Ley (2011) outline how these measures are computed. The adjusted net national income yields a true measure of income and is generally lower than GNI and its growth rate is lower than the GDP growth rate during resource booms. The adjusted net savings measure yields a true measure of wealth creation after accounting for investment in human capital, depletion of natural resources and pollution damage. These ratios need to be computed as follows:

Net national income (NNI) = GDP + net foreign factor income – depreciation of fixed capital

Adjusted net national income (aNNI) = NNI – depletion of natural resources

Gross domestic savings (GDS) = GDP – consumption

Net national savings (NNS) = GDS + net foreign factor income + net transfers – consumption of fixed capital

Adjusted net savings = NNS + education expenditure – depletion of natural resources – pollution damage

It is noteworthy that the adjusted net savings measure classifies education expenditures as development rather than consumption contrary to the practice of the System of National Accounts (SNA).

The IMF's Government Finance Statistics Manual 2001 follows the 1993 System of National Accounts (SNA93) that treats the depletion of natural resources as volume change rather than as capital consumption. Consequently, the depletion of natural resources has no impact on the measured operating balance for government operations. In order to obtain a true measure of the government's fiscal stance, an adjusted measure of the operating balance needs to be computed as follows:

Gross operating balance = Revenue – Expense (excluding consumption of fixed capital)

Net operating balance = Gross operating balance – consumption of fixed capital

Adjusted net operating balance = Net operating balance – depletion of natural resources.

The adjusted net operating balance provides the most comprehensive measure of the government's fiscal stance in countries where fiscal revenues from taxing of natural resources are large.

Furthermore, Hamilton and Ley (2011) outline foundations of sustainable fiscal policy as follows:

- Tracking adjusted measures of the government's net operating balance in order to assess fiscal space;
- Effectively and efficiently taxing the profits on resource exploitation;
- Applying fiscal rules in order to ensure that resource revenues are saved rather than consumed;

- 
- Establishing a natural resource fund in order to assist with stabilisation and ensure that savings are used effectively; and
  - Building a strong public investment management system in order to ensure the quality of public investments financed by resource revenues.

Natural resource funds are in recent years known as SWFs. The goal of SWFs is to transform underground wealth into overground wealth. Consumption of a resource unit today has an opportunity cost equal to the present value of the marginal profit from selling the resource in the future. Thus, a decision maker will always face the choice between the increasing value of the resource if left unexploited, and its current value if extracted and sold. This intertemporal trade-off is the cornerstone of the Permanent Income Hypothesis which states that individuals base their consumption and savings decisions not on their current income, but on the total expected stream of future incomes from employment, investments, inheritance, etc during their lifespan. Wealth is defined as the sum of the discounted stream of expected future incomes. Castelli and Scacciavillani (2012, p. 28) aptly state: “When applied to a country, the Permanent Income Hypothesis states that the population in each period should consume an amount equal to the rate of return on accumulated resource wealth multiplied by the net present value of expected future wealth. This intertemporal equilibrium rule ensures that the current generation shares the proceeds of the natural resources endowment in a way that preserves the endowment for the next generation”. Thus, the hypothesis could be interpreted as providing fairness in intergenerational transfer.

If a country discovers deposits of natural resources but lacks funds to invest in extraction facilities, it has two choices:

- 1) Borrow externally by providing as collateral the future stream of export proceeds. Save part of the revenues until the natural resource is exhausted by building up a SWF large enough for interest on the accumulated financial wealth to maintain consumption increments in perpetuity.
- 2) Auction the exploration and extraction rights to foreign companies in exchange for a stream of royalties over a predefined period of time. This is the normal preference because of lack of technology and project management skills.

Bjerkholt (2002) and Barnett and Ossowski (2003) propose the ‘bird-in-hand’ rule that all resource revenues be saved through a SWF and incremental consumption be restricted to the interest earned on the fund. This is equivalent to the Permanent Income Hypothesis but with the windfall left untouched until it has been fully earned.

Suffice to say that the decision on the consumption-saving trade-off over the proceeds from exports of natural resources depends on a wide set of circumstances and collective preferences and SWFs are often the main of the institutions that implement the strategy adopted.

In the early 1970s economists grappled with the question of sustainability: “If an essential resource like energy is finite in extent, can economic output be sustained indefinitely, or will output eventually begin to decline?” (Hamilton and Ley, 2011, p.135). Solow (1974) demonstrated that consumption can be sustained even with a fixed production technology as long as the share of the exhaustible resource in production is less than that of capital produced, and when there is sufficient substitutability between the two production factors. Hartwick (1977) operationalised Solow’s observation with a simple policy rule now commonly known as the Hartwick rule: invest resource rents in other assets. In this way capital is kept intact.

Despite the challenges in implementing the rule, the World Bank (2011) demonstrated in a counterfactual that resource extracting economies could have been richer than they are now had they implemented the Hartwick rule.

Hamilton (2010) demonstrated that if Sub-Saharan African countries followed the Hartwick rule, their hypothetical produced capital would have been higher than their actual produced capital, and would have higher per capita capital. His estimates under the Hartwick rule show that Gabon would have hypothetical per capita capital of about US\$68,000 compared with actual produced per capita capital of US\$19,000 in 2005. Nigeria would have about US\$5,350 compared with actual of about US\$1,350, and Congo would have about US\$16,000 compared with the actual of US\$3,700.

In essence, the Hartwick rule provides the policy prescription for achieving sustainable fiscal sustainability and growth in exhaustible resource-based economies.



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In order to achieve fiscal sustainability, the following elements need to work efficiently and effectively:

### 1) EFFECTIVE REVENUE INSTRUMENTS

Assuming that exploitation of the natural resource is undertaken by private actors, a government can realise the benefits of ownership through effective and efficient fiscal instruments to capture resource rents. In practice, the ability of government to capture resource rents is constrained. In principle, if resources are extracted by a state-owned enterprise all rents can be captured through flows of profits to the treasury. However, experience has shown that state-owned enterprises are subject to political meddling, lack of commercial orientation and investment finance is limited by government capital budgets. When private actors are involved the issue of information asymmetry arises. Since firms know their costs with precision than government, it is difficult to design the perfect fiscal instrument that captures resource rents, i.e. one that does not depress after-tax profits below “normal” levels or does not leave windfall profits in the hands of private firms.

Governments use a range of fiscal instruments to capture resource rents. Sunley et al., 2003 identified the following:

**Royalties:** These are charged either as specific taxes or administered on gross production value and are unpopular with producers as they bear all down-side market risks while government does not.

**Income taxes:** The government may place restrictions on consolidation of income and tax deductions on exploration, development and production.

**Resource rent taxes:** These endeavour to tax away super-normal profits but they may be no consensus between government and producers on what constitutes super-profits.

**Production-sharing agreements:** These split gross income into a cost-recovery component and a profit component which is shared between producer and government according to an agreed formula.

**Indirect taxes:** These may include tariffs, export duties, and value-added taxes.

Notwithstanding the uncertainties involved in extracting natural resources, a government can only realise the benefits of ownership through effective and efficient fiscal instruments to capture resource rents.

## 2) FISCAL RULES

In natural resource-producing countries resource revenues tend to be a large proportion of both GDP and government budget as well as potential tax revenues. Hence, there is always a temptation for governments to spend resource revenues on consumption. Some governments have implemented fiscal rules to prevent this capital consumption. Fiscal rules are defined as standing commitments to specified numerical targets for some key budget aggregates (Ter-Minassian, 2010). In essence, fiscal rules are motivated by a desire to reduce the procyclicality of fiscal policy arising from volatile resource revenues and to promote savings and sustainability. They play a crucial role in constraining fiscal policy directly.

According to the Inter-American Development Bank (Ossowski, 2013), where adequate technical capacity exists the fiscal rule could target the non-resource budget (NRB) or the non-resource primary budget (NRPB) adjusted for the non-resource cycle, which provides a clearer picture of the underlying policy stance and of discretionary fiscal policy. The targeted NRB or NRPB should be set taking into account long-term fiscal sustainability estimates and vulnerability to resource shocks that should be reviewed as circumstances change. Box I below describes the fiscal rule of Botswana.

### Box I: Fiscal Rule of Botswana

Botswana's fiscal rule is the Sustainable Budget Index calculated as follows:

$$\text{Sustainable Budget Index} = \frac{\text{Recurrent expenditure}}{\text{Recurrent revenue}}$$

Recurrent expenditure excludes spending on health and education which are defined as development expenditure. Recurrent revenue excludes mining sector revenues. The policy aim is that Sustainable Budget Index should not exceed 1 to ensure that resource revenues are not consumed. Resource revenues are invested domestically in infrastructure, health and education, and in financial assets depending on the absorption capacity.

Botswana has been generally successful in following the Sustainable Budget Index. However, the index has temporarily exceeded 1 in the following episodes: 1994-1995; 2000-2001 and 2004-2005.

Source: Hamilton and Ley (2011) and Kojo (2010)

Kopits and Symansky (1998) provide a list of characteristics for an ideal fiscal rule: it should be well-defined, transparent, simple, flexible, adequate relative to the final goal, enforceable, consistent, and supported by sound policies.

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Lessons can also be learnt from the fiscal rule of Chile that is based on a reference price of copper, the country's main export. Its operation is described in Box 2 below.

#### Box 2: The Fiscal Rule of Chile

A fiscal rule was established to smooth fluctuations in copper revenues and related spending in the budget. It defines a structural surplus at a certain level, which in recent years has been 0.5% to 1% of GDP. The surplus target was set so that enough savings can be accumulated to finance future public commitments, in particular a guaranteed minimum pension and old-age benefit, and recapitalisation of the central bank. The surplus target is made of non-oil structural surplus and estimated long-term copper revenues based on a reference price. When copper prices exceed/are below a reference price, that is assumed to reflect a medium-term equilibrium price for copper, revenues are transferred to and from the copper fund. The reference price is set in real terms (adjusted for dollar inflation) and cannot exceed a six-year moving average of the spot price.

The reference price and the potential output used for the deficit rule are estimated by independent expert panels drawn from academia, the financial and the mining sector. For copper, the experts submit their reference price projections for the next 10 years, which is then averaged to get the reference price for the budget each year. These rules have enhanced transparency and discipline in fiscal policy. As automatic stabilisers are small, the fund has enabled Chile to conduct counter-cyclical fiscal policy in downturns, when access to foreign credit has become more expensive. The fund has been successful in reducing output volatility and has made Chile one of the few emerging markets able to conduct strong counter-cyclical fiscal policies.

Source: Fiess (2002); Perry et al. (2008); Rodriguez et al. (2007)

## OPERATION OF SWFs

Even if governments choose to invest resource revenues rather than consume, there are interlinked issues that arise, especially in the context of developing countries; (1) the limited capacity of developing countries to absorb large amounts of investment, (2) the effectiveness of public investment management systems. In the presence of constraints of absorptive capacity in the economy, the alternative is to invest in financial assets through SWFs.

SWFs can achieve three objectives, namely:

- 1) Serve to buffer the economy from the volatility of natural resource markets;
- 2) Limit Dutch Disease symptoms by spreading the conversion of resource receipts into domestic currency over time; and

- 3) Provide a useful source of liquidity for governments concerned with running countercyclical fiscal regimes (Davis et al., 2003).

Crucially, they ensure that the revenues from exhaustible resources are saved rather than consumed but should not be a substitute for overall fiscal discipline and sound budgetary practices. According to Griffith-Jones and Ocampo (2010), in theory accumulation of foreign reserves through SWFs can also be a “self-insurance” against capital flight and provide autonomy in macroeconomic policy.

While SWFs mostly invest in foreign assets, there are increasingly political constituencies calling for strategic domestic investment. Since low-income countries are capital-scarce, Collier et al. (2009) and Sachs (2007) argue for using natural resource revenues to increase public investment domestically, spending them on human capital and physical infrastructure with a high social rate of return. According to the World Bank (Halland et al., 2015), some SWFs established in the millennium have been set up to undertake strategic domestic investment.

For example, Kazakhstan’s Samruk-Kazyna and Malaysia’s Kazanah. Nigeria and Angola have recently established funds with a domestic investment function. Many other countries such as Kenya, Morocco, Myanmar, Mongolia, Tanzania, Uganda, Mozambique and Sierra Leone are said to be contemplating such type of funds.

The World Bank staffers identify four distinct factors driving SWFs as a tool for strategic domestic investment:

- 1) Low and middle-income countries that are contemplating strategic domestic investments have a large infrastructure deficit and hence are looking for ways to increase infrastructure investment.
- 2) There has been a loosening in the interpretation of the permanent income hypothesis that suggests that countries should save enough resource revenues abroad to maintain a permanent income flow into the indefinite future. It is now argued that it makes sense to invest more at home if returns are higher at home than abroad, or if future generations can be expected to be wealthier than the current one. Ideally, allocations to domestic investment should be determined on the basis of competition with the returns on foreign assets.
- 3) The global financial crisis (2007-2009) and diminishing aid flows have resulted in reduced availability of long-term finance for developing

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countries from abroad. Hence, these countries are looking at SWFs investing domestically supplementing foreign capital.

- 4) It is often acknowledged that public investment in low-income countries presents many management and governance challenges such as low capacity, weak governance and regulation, and lack of coordination among public entities. Hence, some governments may view a SWF as a means of improving the quality of public spending, and crowding in private investors to strengthen public investment discipline. Crowding in private investors and co-financing to reduce risks, bring in additional expertise, and enhance the credibility of investment decisions. For example, the Nigeria Infrastructure Fund, the domestic subsidiary of the Nigeria Sovereign Investment Authority, has signed cooperation agreements with the Africa Finance Corporation, the International Finance Corporation (IFC) and with General Electric for power sector investments.

Examples of well-performing SWFs that hold a significant share of domestic assets in their portfolios include: Singapore's Temasek (about 25%), New Zealand's Superannuation Fund (about 17%). They undertake investments on a strictly commercial basis.

Broadly, SWFs can be classified into two categories – stabilisation funds and savings funds. Stabilisation funds are primarily meant to stabilise public finances by buffering the budget from the volatility of resource revenues. They use contingent rules to determine whether funds are accumulating or being withdrawn for use in the government budget. Savings funds, on the other hand, aim to invest a specified proportion of resource revenue. Table 8 lists selected SWFs by objective, accumulation and withdrawal rules across the world excluding African SWFs that are listed separately in Table 9.

**Table 8: Stated Objectives of Selected SWFs outside Africa**

Country/ State	Name:	Stated objective(s)	Date Established	Accumulation rules	Withdrawal rules
Alberta (Canada)	Alberta Heritage Savings Trust Fund	Savings (prior to 1997 economic and social development were also included)	1976	30% of resource revenue until 1983, 1984-87: 15%. Transfers discontinued thereafter.	Discretionary transfers to the budget.
Alaska (United States)	Alaska Permanent Fund	Savings	1976	50% of certain mineral revenues (ã from 25% in 1980).	Principal (Inflation-adjusted).
Chile	Copper Stabilisation fund	Stabilisation	1985 (activated in 1987)	Based on discretionary reference price determined by the government	Transfer to the budget (and extra budgetary lending) based on discretionary reference price determined by the government.
Kuwait GRF	General Reserve Fund	Stabilisation and savings	1960	Residual budgetary surpluses.	Discretionary transfer to the budget.
Kuwait RFFG	Reserve fund for Future	Savings	1976	10% of all government revenue	Discretionary transfer to the budget (with National Assembly approval)
Kiribati	Generations Revenue equalisation Reserve Fund	Stabilisation and Savings	1956	“when surplus permits,” later apparently changed to 25% of all phosphate receipts	Discretionary transfers to the budget with parliamentary approval and that of other officials.
Norway	Government Pension Fund Global	Stabilisation and savings	1990 activated in 1995	Net Government oil revenues.	Discretionary transfer to the budget to finance non-oil deficit (approved by parliament)
Oman SGRF	State and General Reserve Fund	Savings	1980	Since 1998, oil revenue in excess of budgeted amount.	Discretionary transfer to the budget.
Oman OF	Oil fund	Oil sector investment	1993	Since 1998 market value of 15,000 barrels per day.	
Venezuela	Macroeconomic stabilisation fund	Stabilisation	1998	Since 1999, 50% of oil revenue above reference values, set by decree for 1999-2004	Transfer to the budget and other state entities based on reference values; discretionary transfers also allowed.

Source: Hamilton and Ley (2011)

NB: In the majority of the cases in the table except the Kuwait GRF and the Kiribati Fund, accumulation rules are not based on revenue from budget surpluses.

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There are a number of stylised facts about African SWFs listed in Table 9. According to the AfDB there are at least 15 African SWFs pioneered by the establishment of Botswana's Pula Fund and Ghana's Minerals Development Fund in 1993. They are all commodity-based, mainly oil-based. With the exception of Algeria's Fonds de Regulation des Recettes, the Libyan Investment Authority and the Botswana's Pula Fund, African funds are small in comparison with those from other regions. Globally, they only account for less than 2% of value of all SWFs.

The AfDB observes that African SWFs have been subject to regular withdrawals to supplement government budgets and to repay external debt potentially leading to zero savings as there are no limitations on the amount that can be utilised to close budgets. In other words, there are no clear withdrawal rules and where they are in place they are not enforced. There is scant information regarding public disclosure of assets, strategies, rationales and institutional structures. Governance problems arise either from lack of institutional arrangements or from poor enforceability of existing institutional arrangements. Only three funds subscribe to Santiago Principles (discussed in the next section) namely: the Libyan Investment Authority, Botswana's Pula Fund and Equatorial Guinea's Fund for Future Generations.

In order to derive benefits for African economies, the AfDB recommends that African SWFs go beyond their stabilisation and macroeconomic stability motives and position themselves as instruments for achieving economic growth, intergenerational resource transfers, infrastructure financing, financial sector stabilisation, deepening and broadening, and regional integration. Angola's SWF, the Fundo Soberano de Angola (FSDEA) established in October 2012, can be viewed to have followed this advice. The FSDEA is a petroleum-funded US\$5 billion SWF that has an expressed purpose of profit maximisation with a special emphasis on investing in domestic projects that have a social component. However, the IMF (2014) observes that although FSDEA has instituted most of the accepted best international practices for SWFs, transparency and governance still need to be strengthened in areas such the issuance of frequent (quarterly) and timely reports on activities and performance, the timely publication of audit reports, and clear rules for selecting board members and external asset managers. It was further observed transfers to the SWF were linked to the price of oil noting delays in transfer in response to falling of oil prices.

Table 9: SWFs in Africa

SWF Name:	Country:	Date of Establishment:	Funding Source:	Objective	Estimated Assets under management (US\$ bn)
Fonds de Régulation des Recettes	Algeria	2000	Oil	Stabilisation Fund	59.34 (2009)
Fonds de Stabilisation des Recettes Budgétaires	Chad	2006	Oil	Stabilisation Fund	0.003 (2010)
Fundo Soberano de Angola (FSDEA)	Angola	2012	Oil	Development Fund	5.0 (2012)
Pula Fund	Botswana	1993	Diamonds	Development Fund	6.9 (2010)
Fonds de Stabilisation des Recettes Budgétaires	Congo	Unknown	Oil	Stabilisation Fund	1.64 (2010)
Fonds de Stabilisation des Recettes Budgétaires	Equatorial Guinea	Unknown	Oil	Stabilisation Fund	1.39 (2010)
Fonds de Réserves pour Générations Futures	Equatorial Guinea	Unknown	Oil	Development Fund	0.080 (2010)
Fonds de Souverain de la République Gabonaise	Gabon	1998	Oil	Development Fund	0.380 (2010)
Minerals Development Fund	Ghana	1994	Gold and other minerals	Development Fund	
Libyan Investment Authority	Libya	2006	Oil	Development Fund	70 (2010)
Fonds National des Revenus des Hydrocarbures	Mauritania	2006	Oil	Stabilisation Fund	0.03425 (2009)
Minerals Development Fund	Namibia	1995	Minerals	Development Fund	N/A
Excess Crude Funds(Account)	Nigeria	2004	Oil and gas	Stabilisation Fund	3 (2010)
National Oil Account	Sao Tome and Principe	2004	Oil	Development Fund	0.010 (2009)
Oil Revenue Stabilisation Fund	Sudan	2002n	Oil	Stabilisation Fund	0.15 (2009)

Source: Triki, Thouraya and Faye, Issa (2011)

### 3) PUBLIC INVESTMENT MANAGEMENT

Effective public investment management becomes critical in determining development outcomes when governments decide to invest resource revenues



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in infrastructure and other public projects. An improved project evaluation system that significantly increases the rate of economic productivity of public investments has a permanent and continuing effect on a country's growth rate (Harberger, 2005).

The World Bank (Rajaram et al., 2008) has identified the following nine key features to be present in any well-functioning system for public investment management.

- a) Investment guidance and preliminary screening: This must be derived from a national plan that establishes economy-wide development priorities at the highest decision-making levels (e.g. ZIMASSET). All projects should undergo first-level screening to ensure that they meet the minimum criteria of consistency with the strategic goals of the government, including a positive social rate of return.
- b) Formal project appraisal: Projects that pass first-level screening should be subjected to rigorous cost-benefit analysis in terms of both social and economic value. Since this evaluation depends on the capacity and skills of public officials, investment in training should be an important aspect of an effective public investment system.
- c) Independent review of appraisal: In order to avoid subjectivity and self-serving bias in evaluations done by the government departments or ministries, an independent peer review should be undertaken.
- d) Project selection and budgeting: The process of appraising and selecting public investment projects should be linked to the budget cycle.
- e) Project implementation: There must be institutional capacity to implement public investment projects.
- f) Project adjustment: There should be a flexible funding review process.
- g) Facility operation: Asset registers should be maintained.
- h) Post-project evaluation: This should focus on comparing the project's outputs and outcomes with the objectives set in the project design.
- i) Public procurement process: The procurement process must be transparent and rules-based to avoid political interference and wastage of resources.

## SECTION 4: BEST PRACTICES IN BUILDING THE LEGAL FRAMEWORK, INSTITUTIONAL STRUCTURES AND GOVERNANCE OF SWFS

Following consultations, the IMF and the IWG on SWFs launched in October 2008 the Santiago Principles whose goal was to foster trust, openness, transparency and probity in the management of SWFs<sup>6</sup>. These principles have become known as the GAPPs on SWFs and are detailed in Appendix I of this paper. In April 2009 the IWG further established the International Forum of Sovereign Wealth Funds (IFSWF)<sup>7</sup>, a voluntary group of SWFs that meets to exchange views on issues of common interest, and facilitates understanding of Santiago Principles and SWF activities. In essence, the IFSWF promotes best practices in the management of SWFs.

The Santiago Principles comprises 24 GAPPs that are broadly arranged in three pillars (see Appendix I), namely:

Pillar 1: Legal Framework, Objectives, and Coordination with  
Macroeconomic Policies

Pillar 2: Institutional Framework and Governance Structure

Pillar 3: Investment and Risk Management Framework

### PILLAR 1: LEGAL FRAMEWORK, OBJECTIVES, AND COORDINATION WITH MACROECONOMIC POLICIES

The principles governing Pillar 1 are covered in GAPPs 1-5. While the legal

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<sup>6</sup>This was a unique collaborative global effort between countries with Sovereign Wealth Funds, Investment recipient countries and international organisations. The IWG held a number of meetings to establish the 24 Generally Accepted Principles and Practices (GAPP) better known as the Santiago Principles-named after the Chilean Capital hosting the last of a series of international meetings in 2008. With the Santiago Principles, a voluntary and generally agreed global framework for SWFs was established (IFSWF, 2014).

<sup>7</sup>A key aspect of the mandate of the IFSWF is the sharing of views and experiences on how the Santiago Principles are implemented in practice. The focus of this Forum whose Secretariat is headquartered in London is on inclusiveness and voluntary exchange of knowledge (IFSWF, 2014).

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basis and form in which SWFs are established varies from country to country, in most cases they are established by a specific legislation. An IMF survey finds that slightly more than half of existing SWFs are established as separate legal entities. Essentially, three types of legal structures are observed:

- SWFs established as independent legal entities governed by a specific constitutive law such as the Australian Future Fund (FF), the Kuwait Investment Authority (KIA), the Korea Investment Corporation (KIC) and the State Oil Fund of the Republic of Azerbaijan (SOFAZ).
- SWFs set up as state-owned corporations governed by company law. Examples include Singapore's Temasek and Government of Singapore Corporation (GIC), China's China Investment Corporation (CIC).
- SWFs established from a pool of assets owned by the state or the central bank such as the Botswana Pula Fund (PF), the Canada Alberta Heritage Savings Trust Fund (AHSTF), Chile's Economic and Social Stabilisation Fund (ESSF) and the Pension Reserve Fund (PRF), and Norway's Government Pension Fund Global (GPF). The legal framework of such funds is still guided by an Act of Parliament. For instance, the Pula Fund's legal framework is embodied in the Bank of Botswana Act in Section 35 of the Act.

Good practice requires soundness of the overall legal framework and public disclosure. The management of stabilisation funds and excess reserves require coordination with macroeconomic policy objectives. Since most SWFs do not invest domestically, there are no standard procedures for policy coordination with monetary and fiscal authorities.

Since SWFs are created for a variety of reasons, the particular policy purpose for which a particular SWF is created should be clearly defined in relevant legal documents and disclosed publicly. This is important as the policy objective guides the investment policy. If the SWF is created for macroeconomic stabilisation purposes, its operations should be consistent with a sound overall macroeconomic framework. While SWF policy objectives vary, they can generally be grouped as follows:

- Stabilisation funds are established with the primary objective of off-setting macroeconomic volatility in the fiscal balance and the economy. The volatility arises from fluctuating commodity and natural resource prices. The construction of the funds requires them to be counter-cyclical. They have

short- to medium-term investment horizons and the contingent need for liquidity means that the strategic asset allocation is relatively conservative favouring liquid asset classes.

- Savings funds are established with the objective of ensuring inter-generational equity. They tend to have long-term investment horizons and can invest in a countercyclical manner and thus may provide liquidity to global markets.
- Reserve investment corporations are established with the objective of managing excess foreign exchange reserves. They differ from traditional reserve portfolios in that they invest in more diversified portfolios that are more long-term in nature. They can be called upon to supplement the liquid reserves used for sustaining a country's external accounts or exchange rate policy. They also provide liquidity to global markets.

Some SWFs have dual policy purposes. For instance, Azerbaijan's State Oil Fund, the Kuwait Investment Authority, Timor-Leste's Petroleum Fund and Trinidad and Tobago's Heritage and Stabilisation Fund have both a stabilisation and an intergenerational equity policy purpose. Norway's Government Pension Fund Global has both an intergenerational equity and future pension obligations policy purpose while Chile's Economic and Social Stabilisation Fund and Pension Reserve Fund has both a stabilisation and future pension obligations policy purpose.

Funding and withdrawal rules are specific to the SWF type and should be set out in legislation and should be consistent with the policy purpose.

- Stabilisation funds: Funding withdrawal rules are closely linked to the government budget surplus/deficit, with the amount being determined as part of the annual budget process or pre-agreed rules.
- Savings funds: Funding and withdrawal rules are designed to account for known or unknown future liabilities. If liabilities are known with certainty, the rules prescribe a pre-defined minimum contribution. If not known with certainty, withdrawals may only occur when the fund has exceeded a target return objective and good practice would require legislative approval.
- Reserve investment corporations: Funding and withdrawal rules focus on meeting reserve adequacy targets. When reserves exceed the reserve adequacy requirement, funds are transferred to the reserve investment corporation and vice versa when reserves are inadequate.

In order to promote accountability, the source of SWF funding should be publicly disclosed on a regular basis as well as any other statistical data on the SWF. While

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the majority of global SWFs have no standard procedures for policy coordination with monetary and fiscal authorities to achieve macroeconomic policy objectives, stabilisation funds and funds for excess reserves emphasise coordination because they have macroeconomic policy objectives. If the SWF has a policy objective of macroeconomic stabilisation, it would allocate a portion of its portfolio to liquid assets for the purpose of meeting short-term liquidity needs.

## PILLAR 2: INSTITUTIONAL FRAMEWORK AND GOVERNANCE STRUCTURE

The principles governing Pillar 2 are covered by GAPPs 6–17. The institutional framework should provide the SWF with operational independence while ensuring its accountability to government and the public. Often this is achieved by either establishing a separate entity or entrusting the management to the central bank or a unit of the Ministry of Finance while requiring disclosure of audited financial reports and regular reporting to the Ministry of Finance and Parliament.

Where SWFs are set up as separate legal entities, they are usually managed by a Board of Directors and the internal governance structure is similar to the structure of private corporations.

In summary, in order to ensure operational independence of the SWF's management, the following mechanisms are employed:

- The SWF's management is vested in a separate legal entity headed by a governing body with clearly defined responsibility for implementing the broad investment mandate established by government.
- Where the SWF's governing body is not independent, the chief executive and senior managers are provided with extensive powers.
- Responsibility for operational management is vested to the central bank or a statutory body.
- Responsibility for making individual investment decisions is contracted out to external managers on a fee-for-service basis.

The accountability framework should be embodied in the relevant legislation. Often audited annual reports are presented either to the ministry of finance or

parliament depending on the legal structure of the SWF. An example of public disclosure is shown in Box 3 below.

### **Box 3: Timor-Leste's procedure for publishing the SWF's financial information**

The Petroleum Fund annual report and audited financial statements are prepared by the Ministry of Finance and submitted to Parliament. They are also distributed to key stakeholders and are publicly available on the Ministry of Finance website. In addition the operational manager issues quarterly and monthly updates on the investment performance for the Minister of Finance, and this is made available to the general public on the Central Bank's website. The Ministry of Finance, on its own initiative or as requested, conducts public information sessions with the general public – including public servants, NGOs and students – to update them on the fund's activities, operations and performance.

Source: IFSWF (2014)

## **PILLAR 3: INVESTMENT POLICIES AND RISK MANAGEMENT FRAMEWORKS**

The principles of Pillar 3 are covered by GAPPs 18-24. The investment policy should set out how the SWF intends to achieve its defined objectives using the investment strategy formulated by its owner or its governing body. It defines permissible asset classes and provides guidance on concentration risk with regard to individual holdings, liquidity, and geographical and sectoral concentration. If there are external managers appointed via an Investment Management Agreement, the investment policy should set out the extent to which they are used, the range of activities and authority and the process by which they are selected.

The SWF should have a well-functioning risk management framework embodied in Investment Guidelines able to identify, assess, and manage its risks to protect its assets and stay within the tolerance levels as set out in the investment policy.

Finally, GAPP 24 proposes that SWFs should subject their voluntary endorsement of the Santiago Principles to a regular review which process is established through IFSWF membership.

## **CASE STUDIES OF GOOD PRACTICES**

Adherence to Santiago Principles is considered as a barometer for best practices. IFSWF members that regularly subject themselves to review of their practices

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provide global benchmarks to others. In this paper four case studies of SWFs are evaluated regarding their adherence to Santiago Principles. The first case study is that of the Kuwait Investment Authority established as an independent legal entity governed by a specific constitutive law. The second case study is that of the Government of Singapore Corporation (GIC) established as a state-owned corporation. The third and fourth case studies are respectively Botswana's Pula Fund and Norway's Government Pension Fund Global both established as pools of assets owned by the state or the central bank. All the four SWFs are members of the IFSWF.

#### **Box 4: Kuwait Investment Authority (KIA)**

##### **Legal Framework, Objectives and Coordination with Macroeconomic Policies**

KIA was created by a constitutive law as an autonomous governmental body responsible for the management of the assets of Kuwait. It is responsible for the management of Kuwait's General Reserve Fund (GRF), stabilisation and savings fund, and the Future Generations Fund (FGF), a savings fund, as well as other funds entrusted to it by the Minister of Finance for and on behalf of the State of Kuwait. The source of funding is oil revenues.

Public disclosure is enshrined as elected representatives of the National Assembly are regularly informed of KIA's investments and performance. With regard to coordination with macroeconomic policies, KIA provides liquidity to the State's Treasury when needed and its role in the local economy is publicly disclosed via website.

##### **Institutional Arrangements and Governance Structure**

Withdrawals from SWFs are sanctioned by law and the constitution prohibits KIA from borrowing. KIA does not hold majority or controlling interests in the companies in which it invests other than in real estate investment entities and in investment holding companies established for particular transactions.

KIA is an independent public authority managed by its Board of Directors that has complete independence in its decision making process. The composition of the Board is prescribed by law.

##### **Investment and Risk Management Framework**

KIA has a long-term investment horizon and hence has the ability to bear risk and to accommodate short term volatility and invests funds through external fund managers. It has clear guidelines and a strategy in terms of asset allocation that are regularly reviewed and updated.

The Board, Executive Committee of the Board and Senior Management are provided with comprehensive Risk and Performance Management tools and reports to make informed decisions.

Source: IFSWF (2014)

**Box 5: Government of Singapore Corporation (GIC)  
Legal Framework, Objectives and Coordination with Macroeconomic Policies**

GIC is incorporated under Singapore's Companies Act. It is wholly owned by Government whose Investment Mandate sets out the terms of appointment, investment objectives, investment horizon, risk parameters and investment guidelines for managing the portfolio.

The SWF purpose is clearly defined as to achieve good long-term returns for the Government – a reasonable risk-adjusted rate above global inflation over a 20-year investment horizon. Such returns would preserve and enhance the international purchasing power of Singapore's reserves. The SWF invests outside Singapore in line with this mission. This policy purpose is publicly available via website.

The sources of funds for the SWF include proceeds from issuance of Government debt, Government surpluses and proceeds from the Government's land sales. The spending rule is stipulated in the Constitution of Singapore.

Monthly and quarterly reports are submitted to the Accountant-General within the Ministry of Finance.

**Institutional Arrangements and Governance Structure**

The Investment Mandate sets out the terms of appointment, investment objectives, investment horizon, risk parameters and investment guidelines for managing the portfolio. The GIC Board is ultimately responsible for asset allocation and for the performance of the portfolio under its management and is accountable to Government.

The Auditor-General audits the SWF and submits annual report to the President and Parliament. The annual report is publicly available via website.

**Investment and Risk Management Framework**

The Investment Mandate provides the prescribed guidelines and limits with regard to investment decisions. Allocation between internal and external managers is on a competitive basis.

GIC is guided by financial considerations when exercising ownership rights. Risk management is undertaken at all management levels employing a three-pronged approach, viz. (1) managing portfolio risk to ensure appropriate and efficient risk-taking; (2) managing process risk so that investment decisions are well implemented; and (3) managing people risk.

Source: IFSWF (2014)



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## **Box 6: Botswana's Pula Fund**

### **Legal Framework, Objectives and Coordination with Macroeconomic Policies**

Established in 1993, the legal framework is embodied in Section 35 of the Bank of Botswana Act of 1996. Its management is entrusted to the Bank of Botswana which assesses the needs for primary international reserves (invested in the Liquidity Portfolio) and invests the excess of what is needed in the long-term Pula Fund in consultation with the Ministry of Finance and Development Planning.

The major purpose of the Pula Fund is to invest proceeds from non-renewable resources for the benefit of future generations. Policy objectives include a short-term stabilisation objective and a long-term investment objective. Investments are all external to Botswana and hence activities related to the investments do not have any significant direct domestic macroeconomic implications.

#### **Institutional Arrangements and Governance Structure**

The Bank of Botswana Act lays down the governance structure that follows a three-tier structure:

- 1) The Board of the Bank of Botswana manages the SWF. Its members include:
  - + A member from the Ministry of Finance and Development Planning representing Government;
  - + The Governor of the Bank of Botswana; and
  - + 7 independent non-executive directors.
- 2) The Investment Committee that is responsible for the execution of the investment strategy. It is chaired by the Governor and includes experts from the Financial Market Department. The performance review is done by the Finance Department.
- 3) Using both internal management and external managers, the Financial Markets Department actually executes the investment strategy and ensures that the desired asset allocation is attained in financial markets. The Payments and Settlement Department performs back office functions.

#### **Investment and Risk Management Framework**

The SWF is invested in both fixed income securities and global equities. A specialist risk management function is responsible for the assessment of the overall portfolio risk in order to ensure that it is consistent with the specified level of risk tolerance and is in compliance with the Board approved investment guidelines.

Source: IFSWF (2014)

The case study of Botswana's SWF is particularly relevant to Zimbabwe for several reasons. First, the Pula Fund is one of the oldest African SWFs that is well established. Second, it is among the only three African SWFs that subscribe to the Santiago Principles. Furthermore, according to the Linaburg-Maduell Transparency Index compiled by the Sovereign Wealth Fund Institute, the Pula Fund ranks highest among the African SWFs in terms of transparency. Third,

Botswana is one of the only three African countries (that include Angola and Libya) that have joined the IFSWF. Fourth, most African SWFs have adopted investment strategies that emphasise liquidity and hence mainly invest in short-term, liquid government securities and money market instruments while the Pula Fund has invested 59% of its assets in bonds and 13% in cash and restricts its investments to rated assets according an AfDB (2011) study. Hence, it has a relatively long-term view towards investments to offer meaningful lessons. Fifth, the Bank of Botswana is the custodian of the SWF and the SWF of Zimbabwe Act designated the Reserve Bank of Zimbabwe as the custodian of the SWF, and hence there are lessons to be drawn from a further study of the case of Botswana. To this end a study tour was conducted and the lessons learnt from the tour are set out in Appendix 2.

### **Box 7: Norway's Government Pension Fund Global**

#### **Legal Framework, Objectives and Coordination with Macroeconomic Policies**

The SWF is not a separate legal entity and the legal framework is defined by the Government Pension Fund Act. The Ministry of Finance is responsible for the management of the Fund while operational management rests with Norway's Central Bank (Norges Bank). Management arrangements are stipulated in the Act.

The purpose of the SWF which is decreed in the Act is to support government savings to finance the pension expenditure of the National Insurance Scheme and long-term considerations in the spending of government petroleum revenues.

The source of funding is the total cash flow from petroleum activities transferred from the central government budget, the return on the Fund's capital and the net results of petroleum-related financial transactions.

The Government follows a Fiscal Policy Guideline whereby the long-term transfers from the SWF should equal the long-term expected real return of the SWF.

#### **Institutional Arrangements and Governance Structure**

The institutional framework is guided by the Act. As the owner, the Ministry of Finance has formal responsibility for the SWF's management while operational management is conducted by Norges Bank whose mandate is to make investment decisions independently.

#### **Investment and Risk Management Framework**

Investment policy is laid down in the Act. The investment strategy is operationalised by the mandate set by the Ministry of Finance which mandate addresses objectives, risk tolerance and investment strategy.

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## LESSONS FROM NORWAY

The standing committee on industry in the Norwegian Parliament produced “10 oil commandments” in 1971 which principles have shaped the direction of the petroleum policy. These commandments were stated as follows:

1. That national supervision and control of all activity on the Norwegian continental shelf must be ensured.
2. That the petroleum discoveries must be exploited in a manner designed to ensure maximum independence for Norway in terms of reliance on others for supply of crude oil.
3. That new business activity must be developed, based on petroleum.
4. That the development of an oil industry must take place with necessary consideration for existing commercial activity, as well as protection of nature and the environment.
5. That flaring of exploitable gas on the Norwegian continental shelf must only be allowed in limited test periods.
6. That petroleum from the Norwegian continental shelf must, as a main rule, be landed in Norway, with the exception of special cases in which socio-political considerations warrant a different solution.
7. That the State involves itself at all reasonable levels, contributes to coordinating Norwegian interests within the Norwegian petroleum industry, and to developing an integrated Norwegian oil community with both national and international objectives.
8. That a state-owned oil company be established to safeguard the State’s commercial interests, and to pursue expedient cooperation with domestic and foreign oil stakeholders.
9. That an activity plan must be adopted for the area north of the 62<sup>nd</sup> parallel that satisfies the unique socio-political factors associated with that part of the country.
10. That Norwegian petroleum discoveries could present new tasks to Norway’s foreign policy.

According to Norwegian Petroleum Directorate, industry commentators believe that these commandments have been largely observed over the years. One key lesson from Norway’s experience is that policy makers in resource-rich countries need to start the process of setting up a SWF by addressing the key question: how to achieve sustainable growth. Implementing the Hartwick rule (invest resource revenues in other assets) to achieve sustainable growth is one way but requires sound fiscal policy and public investment management. Hamilton and Ley (2011)

emphasise that building wealth through fiscal policy involves (i) effective revenue instruments, (ii) fiscal rules to limit discretion, (iii) the operation of natural resource funds or SWFs, and (iv) effective public investment management.

Organisation for Economic Cooperation and Development (OECD) and IMF authors, Ekeli and Sy (2011), observe that Norway offers a useful benchmark for sub-Saharan Africa's natural-resource-rich countries. Its oil wealth accounts for 9% of the wealth per capita whereas in Sub-Saharan Africa natural wealth accounts for 50% of wealth per capita. The discounted value of labour accounts for 82% of Norwegian wealth whereas both human and social capital in Sub-Saharan Africa only accounts for 35% of total wealth, a proportion that is far much lower than the 60% to 70% in a typical developing country (see Hamilton, 2010). This is indicative of a low return on total assets.

Notably, Norway's wealth is due to other factors other than petroleum and hence its experience highlights the importance of factors other than merely a sound management of natural resources revenues. Unlike most resource-rich developing countries, productivity has been key to the welfare of Norway and not petroleum. According to research, sources of growth in Norway and other rich OECD countries have included an array of factors, namely:

- Stability-oriented macroeconomic policies;
- Flexible and competitive product markets;
- High degree of exposure to foreign trade;
- Flexible labour markets;
- Good education and training;
- Low level of taxation; and
- Significant public spending on research and development.

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## SECTION 5: ASSESSING THE READINESS OF ZIMBABWE IN SETTING UP A SWF

There are a number of considerations that are taken into account when setting up a SWF. Ekeli and Sy (2011), staffers of the OECD and IMF respectively, view the following as key considerations in establishing a SWF:

A country's stage of economic development and the strength of its public sector institutions and political culture; The size of the natural resources, their impact on the real economy, and the choice of savings policy, that is, whether a buffer fund or long-term savings fund; Economic and investment policy choices including transforming the revenues from natural resources to other assets such as human, physical, and financial assets; holding assets domestically or abroad; and diversifying assets and raising returns; The risks and rewards of different allocation choices and how much to spend today and save for tomorrow; and a governance model that distributes responsibilities between various organisations while having clear lines of responsibility and applying disciplinary measures for performance.

Das et al. (2009) of the IMF acknowledges that there are no theoretical models as yet for deciding when to establish a SWF. However, they suggest policy and operational considerations that should be taken into account when setting up a SWF. The ideal approach in setting a SWF is that the government should take it from asset-liability and public debt management perspectives. That is, it should consider the entire government balance sheet –identifying all assets and liabilities including resource values in the ground and future tax revenue. In practice, a SWF is usually set up when some critical mass of balance of payment or fiscal surpluses has been reached and thus explaining why SWFs are often established during or after commodity price booms. SWF can also be set up as a deliberate strategy to achieve short/long-term developmental objectives or long-term savings objectives.

The size of official reserves is one indicator that signals whether reserves should be invested differently, i.e., in the form of a SWF. However, the adequate or optimal level of reserves should be ascertained and agreed upon between the government and the central bank before other institutional arrangements of investing the excess in a SWF. For emerging and developing countries the most relevant indicator is the ratio of international reserves to short-term external debt, the target being the coverage of short-term external debt of all residents and in all instruments and currencies measured by the remaining maturity. For instance, for foreign exchange reserves to be considered for active investment, the main indicator used is the import cover – usually 3 months of import cover as a minimum.

Having determined the size of reserves, the next step is to review the origin and longevity of foreign reserves to determine whether or not they are once-off and likely to continue over time.

The first option a government should follow when it has excess reserves is to repay external loans and reduce them to sustainable levels. The second option in the case where there are no substantial external obligations is to begin managing reserves on the central bank balance sheet with a long-term perspective. After exhausting the two options, a third option is to set up a SWF on the central bank balance sheet or as a separate legal entity.

Zimbabwe came up with a legal framework in the form of the Sovereign Wealth Fund of Zimbabwe Act of 2014 and subsequently set up the SWF in 2015. The circumstances under which the SWF of Zimbabwe is being established are unique from the circumstances under which other SWFs were set up. The policy decision to establish a SWF was made at a time when the country is grappling with a number of challenges including: high debts and arrears; low international reserves; widening balance of payment deficit; binding fiscal space constraints and declining international commodity prices. However, this policy decision provides a strong signal of government's intention to break with the past, build a culture of public saving and leverage on mineral rents in line with the objectives of ZIMASSET. This is evidenced by concurrent efforts to address high debt and arrears through the implementation of the Zimbabwe Debt and Arrears Clearance.

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Strategy<sup>8</sup>; boost investment through improving the Doing Business environment and other policy reforms<sup>9</sup> designed to improve the country's investment and growth prospects. These policy initiatives if successfully implemented will create an enabling environment that will reduce the risks posed by the macroeconomic challenges discussed earlier. These macroeconomic challenges if not addressed have the potential of undermining the noble intentions of establishing a vibrant SWF.

While Zimbabwe has just started setting up a SWF, an evaluation of the Act against international best practices as espoused in the Santiago Principles may provide useful insights that will assist in the management of the SWF (see Table 10)

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<sup>8</sup>The strategy involves the following: clearing the arrears to the three multinational institutions namely the IMF, (US\$110 million), the World Bank US(\$1.114 billion) and the AfDB (\$601 million) by the end of April 2016 using a combination of own resources, bridging and long term loans; development of a new comprehensive Country Financing Programme supported by the AfDB, World Bank and IMF that attracts long term financing to promote growth and debt sustainability and Engagement of the European Investment Bank, the Paris Club and non-Paris Club bilateral creditors for debt resolution on the strength of performance under the Financing Programme.

<sup>9</sup>Zimbabwe launched its inaugural National Competitiveness Report (see [www.necf.org](http://www.necf.org)) on 29 October 2015 which has placed the issue of competitiveness high on the policy agenda. The Office of President and Cabinet is spearheading the Ease of Doing Business Reforms using the Rapid Results Approach. Six thematic groups have been set up to drive the reform agenda: (i) Starting a business; ii) Property registration and construction permits; iii) Protecting investors and enforcing contracts iv) getting credit and resolving insolvency; and v) paying taxes and trade across borders and getting electricity. Furthermore, government is also working on Investment, Diaspora and Mining policies.

**Table 10: Zimbabwe's SWF Act and its adherence to the Santiago Principles**

Santiago Principle	State of adherence
<b>Pillar 1: Legal Framework, Objectives, and Coordination with Macroeconomic Principles</b>	
<p><b>GAPP 1 - Principle</b></p> <p>The legal framework for the SWF should be sound and support its effective operation and the achievement of its stated objective(s).</p> <p><b>GAPP 1.1 - Sub-Principle</b></p> <p>The legal framework for the SWF should ensure legal soundness of the SWF and its transactions.</p> <p><b>GAPP 1.2 - Sub-Principle</b></p> <p>The key features of the SWF's legal basis and structure, as well as the legal relationship between the SWF and other state bodies, should be publicly disclosed</p>	<p>The institutional framework for Zimbabwe's SWF is established under the Sovereign Wealth Fund of Zimbabwe Act of 2014. The Minister of Finance administers the Act.</p> <p>The SWF to be known as the SWF of Zimbabwe is a separate independent legal entity which is one common and accepted legal form in establishing SWFs.</p> <p>The Act establishing the SWF is a public document that can be purchased at a nominal cost from the Government Printers shops. No website created to make fully publicly available.</p>
<p><b>GAPP 2 – Principle</b></p> <p>The policy purpose of the SWF should be clearly defined and publicly disclosed.</p>	<p>The purpose of the Fund is clearly stated in section 4 of the Act as:</p> <ol style="list-style-type: none"> <li>To make secure investments for the benefit and enjoyment of future generations of Zimbabweans; and</li> <li>To support the development objectives of the Government, including its long-term economic and social development; and</li> <li>To support fiscal or macroeconomic stabilisation, in particular to supplement (in accordance with this Act and the Finance Act) the revenues of Zimbabwe when these are prejudiced by the fluctuation of prices payable for those minerals on which royalties and other taxes are collected for the benefit of the Consolidated Revenue Fund; and</li> <li>To contribute to the revenues of Zimbabwe from the net returns on its investments in accordance with section 21 (with regard to payment of dividends).</li> </ol>
<p><b>GAPP 3 – Principle</b></p> <p>Where the SWF's activities have significant direct domestic macroeconomic implications, those activities should be closely coordinated with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies.</p>	<p>Section 16 (c) of the Act states: "to the extent that the investment mandate permits investment in domestic assets, no such investment may be made in Zimbabwe Government debt, lending domestic or providing Government guarantee."</p>
<p><b>GAPP 4 – Principle</b></p> <p>There should be clear and publicly disclosed policies, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal and spending operations.</p> <p><b>GAPP 4.1 - Sub-Principle</b></p> <p>The source of SWF funding should be publicly disclosed.</p> <p><b>GAPP 4.2 – Sub-Principle</b></p> <p>The general approach to withdrawals from the SWF and spending on behalf of government should be publicly disclosed.</p>	<p>Section 14 (1) of the Act specifies sources of funds to be deposited in the SWF, viz:</p> <ol style="list-style-type: none"> <li>Such portion (not exceeding a quarter) of royalties in respect of minerals;</li> <li>Such portion not exceeding one quarter of the "special dividend" on the sales of diamonds, gas, granite and other extractables by or on behalf of the MMCZ payable to the Consolidated Revenue Fund;</li> <li>Any moneys appropriated by an Act of Parliament;</li> <li>The profits and proceeds of the investments of the SWF;</li> <li>Any moneys received by the SWF under any contract of insurance effected by the Board; and</li> <li>Such other moneys that may accrue in the course of the operation of the SWF.</li> </ol>



	<p>7. Section 23 of the Act lays out the rules for withdrawals. However, while withdrawal rules are closely linked to the government budget surplus/deficit, the amount is not determined as part of the annual budget process or pre-agreed rules as per good practice. IFSWF (2014) notes that in most cases withdrawals are made within the Government budget framework to ensure consistency with other macroeconomic policies.</p>
<p><b>GAPP 5 – Principle</b> The relevant statistical data pertaining to the SWF should be reported on a timely basis to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets.</p>	<p>In terms of section 12 of the Act, the Board of the SWF should submit quarterly and annual reports as well as occasional reports when required to the Minister of Finance which reports the Minister shall table before Parliament.</p>
<p><b>Pillar II: Institutional Framework and Governance Structure</b></p>	
<p><b>GAPP 6 – Principle</b> The governance framework for the SWF should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate accountability and operational independence in the management of the SWF to pursue its objectives.</p>	<p>The Minister of Finance representing the Government provides the Board of the SWF with the investment mandate which the Board implements independently. The Board is accountable for the overall portfolio performance and is ultimately accountable to the Government for the effective management of the SWF.</p> <p>Section 25 of the Act provides for the audit of the SWF by the Auditor-General.</p>
<p><b>GAPP 7 – Principle</b> The owner should set the objectives of the SWF, appoint the members of its governing body(ies) in accordance with clearly defined procedures, and exercise oversight over the SWF's operations.</p>	<p>The SWF's objectives are set out in Act. With the approval of the President, the Minister of Finance appoints the Board in terms of section 6 of the Act.</p>
<p><b>GAPP 8 – Principle</b> The governing body(ies) should act in the best interests of the SWF, and have a clear mandate and adequate authority and competency to carry out its functions.</p>	<p>The First Schedule of the Act provides guidelines for the appointment, renewal or removal of board members as well as with regard to the engaging of investment managers and consultants.</p>
<p><b>GAPP 9 – Principle</b> The operational management of the SWF should implement the SWF's strategies in an independent manner and in accordance with clearly defined responsibilities.</p>	<p>The Act allows the SWF management to operate independently from Government. It executes investment strategies and is responsible for all investment transactions and reports regularly to the Minister of Finance who represents the Government.</p>
<p><b>GAPP 10 – Principle</b> The accountability framework for the SWF's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement.</p>	<p>The accountability framework is clearly defined in the Act in Section 12.</p>

<p>GAPP 11 – Principle</p> <p>An annual report and accompanying financial statements on the SWF’s operations and performance should be prepared in a timely fashion and in accordance with recognised international or accounting standards in a consistent manner.</p>	<p>The Act requires the production of an annual report that includes:</p> <ul style="list-style-type: none"> <li>• The investment mandate adopted by the Minister and the investment guidelines determined by the Board;</li> <li>• The performance of the Fund;</li> <li>• An assessment of the internal and external audits and risk management control systems in place;</li> <li>• The audited financial statements of the Fund;</li> <li>• All payments to and transfers from the Fund; a list of names of persons holding positions relevant to the operations and performance of the Fund; and any other information relevant to the management of the Fund.</li> </ul> <p>The report is required to be submitted not later than sixty days after the end of the financial year.</p>
<p>GAPP 12 –Principle</p> <p>The SWF’s operations and financial statements should be audited annually in accordance with recognised international or national auditing standards in a consistent manner.</p>	<p>The Act provides for an independent audit by the Auditor-General whose report is tabled in Parliament by the Minister of Finance.</p>
<p>GAPP 13 – Principle</p> <p>Professional and ethical standards should be clearly defined and made known to the members of the SWF’s governing body(ies), management and staff.</p>	<p>Sections 28, 29 and 30 of the Act clearly spell out professional and ethical standards as well as penalties.</p>
<p>GAPP 14 – Principle</p> <p>Dealing with third parties for the purpose of the SWF’s operational management should be based on economic and financial grounds, and follow clear rules and procedures.</p>	<p>Section 9 of the Act provides for the appointment of investment managers through an open, competitive and transparent process.</p>
<p>GAPP 15 – Principle</p> <p>SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate.</p>	<p>Section 27 of the Act states that the Board of the Fund shall operate in accordance with the laws of the country in which the Fund has made an investment as well as the Money Laundering and Proceeds of Crime Act.</p>
<p>GAPP 16 – Principle</p> <p>The governance framework and objectives, as well as the manner in which the SWF’s management is operationally independent from the owner, should be publicly disclosed.</p>	<p>The governance framework and objectives, as well as the manner in which the SWF’s management is operationally independent from the owner is spelt out in the Act i.e. specific functions of the Board (section 7). While, the Act is a public document that can be purchased at the Government printers, disclosure to the generality of the population within and outside Zimbabwe can be improved through creating a dedicated website in line with the e-government programme.</p>
<p>GAPP 17 – Principle</p> <p>Relevant financial information regarding the SWF should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in recipient countries.</p>	<p>While this information is tabled in Parliament, it is not publicly available via a website. In other jurisdictions the Board also issues public quarterly updates on performance and asset allocation (i.e. <a href="http://www.futurefund.gov.au/investment/portfolio_updates">www.futurefund.gov.au/investment/portfolio_updates</a>).</p>
<p>Pillar III: Investment and Risk Management Framework</p>	

<p>GAPP 18 – Principle</p> <p>The SWF’s investment policy should be clear and consistent with its defined objectives, risk tolerance, and investment strategy, as set by the owner or the governing body(ies), and be based on sound portfolio management principles.</p> <p>GAPP 18.1 – Sub-Principle</p> <p>The investment policy should guide the SWF’s financial risk exposures and the possible use of leverage.</p> <p>GAPP 18.2 – Sub-Principle</p> <p>The investment policy should address the extent to which internal and/or external investment managers are used, the range of their activities and authority, and the process by which they are selected and their performance monitored.</p> <p>GAPP 18.3 – Sub-Principle</p> <p>A description of the investment policy of the SWF should be publicly disclosed.</p>	<p>In terms of section 15 of the Act, the Board is empowered to create the following sub-funds:</p> <ol style="list-style-type: none"> <li>1. General Investment Sub-Fund to achieve the objective of securing investments for the benefit and enjoyment of future generations;</li> <li>2. Infrastructure Development Sub-Fund to achieve the objective of supporting the development objectives of the Government including its long-term economic and social development;</li> <li>3. Stabilisation Sub-Fund to achieve the objective of supporting fiscal or macroeconomic stabilisation;</li> <li>4. Other Sub-Funds as the Board considers expedient to establish for the purpose of achieving the objects of the SWF.</li> </ol> <p>The Reserve Bank of Zimbabwe is the primary custodian of the Fund. The following principles apply to the investment of the Fund:</p> <ol style="list-style-type: none"> <li>1. The Fund must be invested in conformity with the Board’s investment mandate;</li> </ol>
	<ol style="list-style-type: none"> <li>2. Investment must be in gold bullion, stockpiles of precious stones and other precious metals, and foreign assets; and</li> <li>3. To the extent that the investment mandate permits investment in domestic assets but not in Government debt, domestic general lending or providing Government guarantees.</li> <li>4. Section 18 of the Act lays down the principles of the investment mandate which are required to be in line with the Santiago Principles.</li> </ol> <p>However, the investment policy is not publicly disclosed as is required by section 16 (5) of the Act.</p>
<p>GAPP 19 – Principle</p> <p>The SWF’s investment decisions should aim to maximise risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.</p> <p>GAPP 19.1 – Sub-Principle</p> <p>If investment decisions are subject to other than economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed.</p> <p>GAPP 19.2 – Sub-Principle</p> <p>The management of a SWF’s assets should be consistent with what is generally accepted as sound asset management principles.</p>	<p>The Board of the Fund is required to maximise risk-adjusted returns as is required by section 7 of the Act.</p>
<p>GAPP 20 -Principle</p> <p>The SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.</p>	<p>This is not specifically stated in the Act but might be available in the unpublished investment policy.</p>

<p>GAPP 21 – Principle</p> <p>SWFs view shareholder ownership rights as a fundamental element of their equity investments' value. If a SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. The SWF should publicly disclose its general approach to voting securities of listed entities, including the key factors guiding its exercise of ownership rights.</p>	<p>The SWF is new and its general approach to voting securities of listed entities including the key factors guiding its exercise of ownership rights are still in their infancy or yet to be developed.</p>
<p>GAPP 22 – Principle</p> <p>The SWF should have a framework that identifies, assesses and manages the risks of its operations.</p> <p>GAPP 22.1 – Sub-Principle</p> <p>The risk management framework should include reliable information and timely reporting systems, which should enable the adequate monitoring and management of relevant risks within acceptable parameters and levels, control and incentive mechanisms, codes of conduct, business continuity planning, and an independent audit function.</p> <p>GAPP 22.2 – Sub-Principle</p> <p>The general approach to the SWF's risk management framework should be publicly disclosed.</p>	<p>This framework should be embodied in the investment mandate which is not yet publicly available as is required by section 16 (5) of the Act.</p>
<p>GAPP 23 – Principle</p> <p>The assets and investment performance (absolute and relative to benchmarks, if any) of the SWF should be measured and reported to the owner according to clearly defined principles or standards.</p>	<p>This is provided for in section 12 of the Act.</p>
<p>GAPP 24 – Principle</p> <p>A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the SWF.</p>	<p>Since the Act explicitly embodies the Santiago Principles, regular review is expected.</p>

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## 5.1 GENERAL ADHERENCE TO SANTIAGO PRINCIPLES

The SWF of Zimbabwe Act explicitly subscribes to Santiago Principles by restating them in the Third Schedule of the Act. The Act lays out legal, governance and institutional arrangements that are to a large extent consistent with the GAPPs (Santiago Principles) governing SWFs. The challenge that remains for the Board and management of the SWF is to enforce institutional arrangement and devise innovative strategies to propel the growth of the SWF which was set up in 2015 given the fiscal space constraints. An AfDB (2011) study observes that governance issues may still arise from poor enforceability of existing institutional arrangements. Furthermore, the study observed that home country reputation is a major determinant of the image, transparency and governance of a SWF.

Notwithstanding the good legal and regulatory framework, there are some sections that may need to be reconsidered with a view of enhancing transparency and operational independence of the SWF to facilitate its smooth implementation.

- Public disclosure of the Act is limited despite the Act's provision for the requirement of public disclosure in section 16. The Act is not easily accessible to the public, for example, the Act is not available via a website. Since the SWF is yet to have a website, the government may consider using websites of other government agencies to widely disseminate the Act.
- Section 11 of the Act states that, "the Minister may give the Board directions in the national interest". This can be considered as limiting the operational independence of the Board regarding the administration of the Fund. In terms of GAPP 6 Principle, once the Board has obtained its investment mandate from Government setting out the terms of appointment, investment objectives, investment horizon, risk parameters and investment guidelines for managing the Fund, the Government should neither direct nor interferes in the Fund investment decisions. It should leave the Board to be accountable for the overall portfolio performance.
- The Act does not provide a limit on how much can be withdrawn from the SWF for purposes of closing a budget deficit. Good practice requires withdrawal rules to be closely linked to the government budget surplus/deficit, and the amount to be determined as part of the annual budget process or pre-agreed rules.
- The Act does not provide for the criteria of allocating resources among the segregated accounts of the Fund.
- The Act explicitly specifies the types of assets that the fund should invest in.

This can limit the flexibility of the investment strategy required in responding to changes in market conditions to meet the objectives of the SWF.

- The Act omits a clear requirement for the establishment of a Future Generations Fund among the segregated accounts of the fund mentioned in Section 15, yet Section 4 of the Act lists as one of the objectives of the Fund “to secure investments for the benefit and enjoyment of future generations of Zimbabweans”. The government may consider explicit mention of the Future Generation Fund in the Act.
- The Act provides for withdrawals from the Fund for purposes of Budget stabilisation, but there is no specific mention of what exactly can be withdrawn – i.e. is it the Fund’s capital or is withdrawal strictly restricted to interest accruing to investments made by the Fund’s management? It is also not clear whether or not such withdrawals are supposed to be paid back to the Fund.
- The Act has chosen royalties as the main instrument for capturing mining rents out of simplicity when profit taxes and rent taxes could have been better instruments. This is in line with the 2008 SWF survey from 20 members of the IWG from four different continents which reveals that 65% of the respondents indicated that the primary source of the SWF is mineral royalties (IWG, 2008 and Hammer et al., 2008). As the AfDB (2015) observes in the case of Botswana, mining rents are better captured using a balanced mix of royalties, profit tax and progressive rent taxes. There is scope for amending the Act to provide for such balanced mix approach.

## 5.2 MACROECONOMIC READINESS TO ESTABLISH SWF IN ZIMBABWE

The fact that natural resources are exhaustible has implications for both how economic performance is measured and how a government leverages natural resources for development. Exhaustibility of mineral resources raises further questions on how we should measure economic performance and design sustainable fiscal policies.

Since GDP growth might not be an appropriate measure of economic performance for economies that depend on exhaustible resources, two alternative national accounting measures are needed for resource-extracting economies, namely: adjusted net national income and adjusted net savings that take account of the depletion of natural resources. Furthermore, in order to obtain a true measure of the government’s fiscal stance, an adjusted measure of the operating balance needs to be computed. The adjusted net operating balance is considered the most comprehensive measure of the government’s fiscal stance in countries where fiscal revenues from taxing of natural resources are large. Table 11 provides estimates of the adjusted measures of economic performance for Zimbabwe.

**Table 11: Adjusted measures of economic performance for Zimbabwe in the face of exhaustibility, 2009 - 2013**

	2009	2010	2011	2012	2013
Nominal GDP (US\$billions)	8.15708	9.45681	10.95623	12.47242	13.49023
Real GDP (\$billions)	8.15708	9.08502	10.16663	11.24075	11.74479
Nominal NNI (US\$)	8,564,689,400	9,232,005,868	10,028,731,506	11,490,085,368	12,446,765,142
Adjusted NNI (current US\$)	8,302,579,560	8,724,438,204	9,205,753,418	10,607,849,484	11,622,440,918
Adjusted NNI (constant US\$2005)	5,213,137,294	5,201,627,450	5,161,029,522	5,871,199,716	6,304,271,513
Value (% of GDP)	8.48	18.21	22.72	20.18	18.62
Total natural resources rents (% of GDP)	8.3	9.7	12.2	12.1	10.7
Coal rents (% of GDP)	1.0	1.6	2.3	1.4	1.0
Forest rents (% of GDP)	5.5	4.2	4.1	4.5	4.2
Mineral rents (% of GDP)	1.8	3.9	5.8	6.2	5.4
Natural gas rents (% of GDP)	0.0	0.0	0.0	0.0	0.0
Gross Domestic Savings (GDS)-current US\$	(633,902,471)	(34,373,393)	(1,367,267,707)	(1,814,875,759)	(1,947,916,506)
Net National Savings (NNS)	699,909,529	313,724,275	(1,481,962,801)	(1,736,707,091)	(1,801,851,364)
Adjusted Net Savings	879,342,343	28,498,420	(2,063,733,480)	(2,342,604,658)	(2,326,847,605)

Source: World Bank Development Indicators

In Table II above the adjusted net savings measure that classifies education expenditures as development rather than consumption clearly shows the true extent of dis-saving in the economy since 2011. Running a budget deficit while also accumulating resources in the SWF results in zero (or even negative) savings and thus compromising intergenerational equity and long-term fiscal and macroeconomic sustainability. The Government's stance to reduce debts and arrears to sustainable levels through the implementation of the Zimbabwe Debt and Arrears Clearance Strategy is commendable. This will reduce risk of withdrawal from the nascent SWF as well as reduce the financial burden on future generations while improving economic growth prospects.



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## SECTION 6: STAKEHOLDER VIEWS

Stakeholders interviewed included representatives from the Ministry of Finance, Ministry of Mines and Mining Development, Reserve Bank of Zimbabwe, Asset Management companies, representatives of various mining boards and experts with knowledge of managing SWFs. Their views are summarised below.

Generally stakeholders understand the SWF as state owned investment vehicle usually funded from budget and trade surpluses established for various reasons which include: development, budget smoothing, preservation of revenues from finite resources, managing excess wealth, etc. They also noted that SWFs invest in stocks, property, private equity and other assets that help to prop up the economy. Given sound governance, SWFs can also be used as ring-fencing mechanisms of specific inflows against fiscal misappropriation.

### AWARENESS OF ZIMBABWE'S INTENTS TO SET UP A SWF

A number of stakeholders indicated that they were aware that Zimbabwe is in the process of setting up a SWF, some through the media and others through workshops not specifically related to the establishment of a SWF. Stakeholders were also aware that a SWF of Zimbabwe Act was gazetted in November 2014; the SWF Board mandate was finalised in July 2015; five of the nine board members have been appointed; the SWF will be primarily funded by 25% of royalties from mineral exports and special dividends on sales of diamonds, gas, granite and other minerals through the ZMDC; and that RBZ will be primary custodian of the fund.

Although interviewed stakeholders were aware of the developments of the SWF, there is scope for increased publicity of this new institution and its benefits to the generality of the population. Lessons can be drawn from other countries experiences on public disclosures and publicising of the activities of the SWF (see case studies in IFSWF, 2014).

### CONDUCTIVE CONDITIONS FOR SETTING UP A SWF

Stakeholders highlighted numerous conditions that they considered conducive for the establishment of a SWF. They highlighted the importance of stable macroeconomic environment which encompass the following:

- Stable fiscal regime with more or less balanced current budget (budget surplus) – there is need for running a surplus on the operational/current budget and invest the surplus into the SWF. Employment costs should ideally be 25% of total budget or less. If there is a budget deficit, it should be between 2-3% and not more than 5% of gross domestic product (GDP). This is in line with the SADC Macroeconomic Convergence target of 3% of GDP as anchor with a range of 1%. Norway, Kuwait, Libya, Botswana and other countries had budget surpluses when they established a SWF.
- Balance of payments surplus and
- Sustainable debt levels.

Apart from the importance of macroeconomic stability, the stakeholders also highlighted other factors that include:

- Fiscal discipline is needed – i.e. having budget expenditure rules and adhering to those rules including clearly stating that the fund is not for consumption but investment.
- The political economy must guarantee operational autonomy of the asset manager to mitigate undue influence;
- Need for transparency on revenues;
- Good corporate governance – stakeholders highlighted the need to learn from other countries avoidable practices such as recruitments not based on merit; conflict of interest and undue political influences leading to premature withdrawals from the fund among other practices.
- Exchange controls that allow the fund to diversify investment offshore in order to limit exposure to domestic risk. However, there is need to balance risk diversification and domestic utilisation of resources generated locally. Currently the Minister of Finance proposed 5% of investment to be made offshore but stakeholders are proposing 30%;
- Ideally, mineral prices need to be increasing rather than declining to enhance the potential size of resources that can be set aside for the SWF;
- Sacrifice part of resource revenues and invest them into the SWF;
- Adequate capacity to run a SWF and this includes skills of portfolio management and investment strategy formulation among other skills;
- Good governance – ideally a SWF would be successful when there is transparency, accountability, operational independence, and zero tolerance to corruption.

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## Is ZIMBABWE READY TO SET UP A SWF?

Stakeholders acknowledge that a policy decision has been made and SWF has been established; the Board has been appointed and provision for seed funding has been made by Treasury. While they endorsed the policy decision they still expressed caution given the economic context and the challenges that government is grappling with. It was noted that the policy intentions are noble and the decision reflected government's commitment to take the necessary sacrifice. These views were based on the observation that Zimbabwe needs to leverage on its natural resources and accumulate resources to facilitate inter-generational wealth transfers. Stakeholders also noted that other mineral rich countries established SWF albeit under different macroeconomic context to what is obtaining in Zimbabwe. Furthermore, stakeholders acknowledge that the mineral resources are finite and hence the country has no choice but to establish a SWF to retain part of the wealth for future generations. However, the stakeholders were quick to highlight some areas of concern that need to be considered as the SWF is being operationalised to mitigate the associated risks. For example the country needs to address the issue of:

- Limited fiscal space and containing budget deficits and/or domestic arrears accumulation – Stakeholders noted that Zimbabwe's fiscal resources are under pressure and the country has not had a budget surplus for many years. In this regard, they were of the view that it would be difficult for the country to save for purposes of investing into the SWF.
- Lack of transparency on revenues – Stakeholders noted the need to draw lessons from the funds created by Government to inform the operationalisation of the SWF with regards to investment strategies and transparency in the use of funds for example, National Social Security Authority (NSSA).
- Lack of fiscal rules that instil fiscal discipline – the country has not been following any fiscal rules except recently when the Government made commitments to follow fiscal targets under the Staff Monitored Program.
- Restrictive exchange controls – these can limit possibilities to partner with or invest in other countries. Requirements for infrastructure funding and debt commitments outweigh the benefits of setting up a SWF at this time.
- Stronger US dollar – affects competitiveness of Zimbabwean exports which has negative implications to export revenues. Underperformance of exports accompanied by drought induced increase in imports will result in the widening of the current account deficit making it difficult to raise funds for the SWF.

Some stakeholders thought that because of the aforementioned conditions currently obtaining in the country, it is not ideal for Zimbabwe to set up a SWF. However, other country experiences reviewed in this paper have shown that not all countries that established SWF were running budget and BOP surplus. When Government made the policy decision it was conscious of the challenges presented by the prevailing macroeconomic environment. It is instructive to note that concurrently government has initiated a series of economic and legislative reforms to achieve the objectives of ZIMASSET. In this regard, economic and legislative reforms have the potential to improving the macroeconomic environment which will reduce the risks in the implementation of the SWF.

## WHO SHOULD MANAGE THE SWF?

International experiences in the management of SWF have underlined the need to get the right skills mix and experience of the people who will run and manage the SWF. These include qualified fund managers with experience in international portfolio management with foreign exchange element. The qualifications include Chartered Financial Analysts (CFAs), Certified Financial Consultants (CFCs), etc. The three key positions suggested were: Chief Investment Officer and two Portfolio Managers. For example, the Government of Botswana located the Pula Fund in the Bank of Botswana to leverage on the skills and experience resident within the Bank which among its other responsibilities is the management of foreign reserves. Other countries have located the SWF outside the Central Bank as an independent entity. In this regard the SWF needs to be adequately resourced to recruit the Staff with the requisite knowledge and experience. A portion of the fund should be managed by local fund managers while another portion is managed by foreign fund managers according to a set out criteria. The contributions of asset managers could be determined by the performance of the portion of the SWF that they manage.

## SOURCES OF FUNDING

Several sources identified by stakeholders were as follows:

- Need for an additional levy apart from the current 25% royalties; New sources of revenues from new mining projects can be wholly earmarked for the SWF because current sources of revenue are not adequate e.g.
  - \* Seed capital from government in the form of cash and minerals e.g. in Angola the government invested US\$5 billion and committed 100,000 barrels of oil per month for the fund. Moreover, Oman's Oil Fund invested the market value of 15,000 barrels per day since 1998.

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- \* Gas project in Lupane;
  - \* Mwenezi iron ore project,
  - \* Consolidating community share ownership schemes into the SWF;
  - \* Transfer excess funds from RBZ and pension fund to the SWF;
  - \* Consider raising a bond to finance the SWF;
  - \* A portion of proceeds from sale or leasing of state land; and
  - \* Consider a fund outside the country targeting Zimbabweans in the diaspora.
- A percentage of proceeds from extracting or exploiting of other natural resources, i.e., airwaves, water etc. can be earmarked for the SWF.

## COUNTRY'S CAPACITY TO MANAGE A SWF

Stakeholders acknowledged that the SWF management is skills' intensive. However, they were of the view that the existence or lack of local capacity to manage the fund is not a critical issue since skills can be outsourced. What is important is the capacity to appoint and monitor fund managers. There is need to draw up rules and guidelines to select and contract good portfolio managers and the capacity to monitor them to avoid speculation on the fund. Nevertheless, local capacity exists in the form of RBZ division that deals with markets and domestic private investment companies. However, the RBZ division has not been very active in portfolio management over the years because of inactive local markets. Among other private local investment companies who can manage mentioned by stakeholders include Zimbabwe Asset Management Company (ZAMCO), Old Mutual, IMARA Asset Managers, First Mutual and CBZ Datvest Asset Managers among others. All these companies have funds that are sizable. They have fund managers and economists.

The practice elsewhere is to distribute the fund among different managers according to their abilities. It was noted that there may be a gap in the form of experts with demonstrable achievements for a very long time. It was also mentioned that there is need for managers who have experience of holding pension funds which have a long-term horizon just as in the case of a SWF. However, for the existing institutional capacity there is need for an enabling institutional support from government, particularly in the form of realistic mandates and/or autonomy from undue influence. As the SWF is being operationalise it may be instructive to undertake a skills and experience gap analysis in the market for fund managers.

## SHOULD THE FUND INVEST LOCALLY OR OFFSHORE?

The stakeholders noted that this is a key decision that has to be made and involves drawing up investment policy/guidelines for the fund which put parameters and limits to invest offshore and domestically. The guidelines would address this issue under the geographic asset allocation. Ideally a small portion should be invested outside the country given Zimbabwe's infrastructure needs. It is important that the guidelines for investment leave room for offshore investment. Some stakeholders were of the view that there should be no prescribed asset ratios for investment. However, prescribed asset ratios would ensure that resources are directed towards intended investments for the SWF. The AfDB is currently working on the guidelines for investment that African countries would use for their SWFs.

## TYPES OF INVESTMENT THAT THE FUND CAN MAKE DOMESTICALLY

Stakeholders indicated that this is essentially determined by the objectives or type of the fund being set up. It also depends on the capacity of the local economy to absorb the type of investment. The stakeholders also mentioned that investment in bonds is not ideal in an environment with a weak currency. Some of the investment options noted by stakeholders are investment in assets that can be used for hedging, equity and alternative investments.

## MANAGEMENT FEES

Outside Africa the funds are very big such that the fees would range between 0.8% - 1.5% of the value of assets under management. However, with small funds being managed, in Zimbabwe on average the fees are 1% but First Mutual and Old Mutual have fees on the lower end. There is a possibility of negotiating fees of 0.05%. Depending on the size of the fund, the fees can range between 0.75% - 1% per annum for other local asset managers.

## EFFECTIVENESS OF THE TAX INSTRUMENTS

The stakeholders perceive that the current tax regime scares away investors by adding to the total cost of production. Government is working on the mining fiscal regime which hopefully will address the concerns of players in the mining sector while meeting the objectives of government. In this regard further work is still required to determine the optimal fiscal regime and effectiveness of the tax instruments being deployed by government.

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## SECTION 7: CONCLUSION, RECOMMENDATIONS AND POLICY CONSIDERATIONS FOR ZIMBABWE

This study sought to identify best practice in establishing and managing a SWF in order to inform and support the policy process of developing and managing a SWF in Zimbabwe. The study also sought to provide actionable recommendations to policy makers and practitioners on mineral resources management using commodity SWFs. Adherence to the Santiago Principles is considered as a barometer for best practices for establishing and managing a SWF. According to the Santiago Principles good practice requires: the soundness of the overall legal framework and public disclosure; an institutional framework which provides operational independence while ensuring accountability to government and the public; and an investment policy that guides how the SWF intends to achieve its defined objectives using the investment strategy formulated by the government or governing body. The key lessons that emerged from the Botswana study tour show that managing a SWF requires highly specialised skills, fiscal discipline, disclosure and membership to IFSWF.

While the study finds out that there are no theoretical models as yet in literature to decide when to establish a SWF, in practice the establishment of SWFs have been influenced by the country's strategic choices and initial conditions prevailing in the country. The initial conditions under which Zimbabwe's SWF is being established are unique and challenging relative to the conditions that existed when other SWFs were established. In Zimbabwe the initial conditions are characterised by high external debt, low international reserves, tight fiscal space constraints and high BOP deficit which present challenges in the establishment of SWF. Cognisant of these initial conditions Government needs to continue to implement concurrent and complementary policy initiatives to strengthen the macroeconomic fundamentals that will facilitate the growth of the SWF.

The Sovereign Wealth Fund of Zimbabwe Act is by and large consistent with the Santiago Principles and explicitly commits to observation of those principles. However, the Act provides discretionary powers to the Minister to influence

the decisions of the Board of the SWF which may undermine operational independence of the SWF as noted in Santiago Principles. The Act also lacks clarity on the withdrawal of funds, limits responsiveness of the investment strategy by explicitly stating assets that can be invested into by the SWF, lacks explicit provision for a future generations fund, is not easily accessible to the public, and lacks the criteria for allocating resources among segregated accounts of the SWF.

In conclusion the study offers recommendations with regard to four key areas: (1) strengthening macroeconomic fundamentals (2) addressing shortcomings in the current Act, (3) capacity building to manage natural resources and the SWF, and (4) long-term policy considerations.

## STRENGTHENING MACROECONOMIC FUNDAMENTALS TO SUPPORT ESTABLISHMENT OF SWF

Notwithstanding that Zimbabwe has already started the process of setting up its SWF, measures should still be put in place to address macroeconomic fundamentals that underpin the successful establishment of SWFs.

Firstly, cognisant that the SWF is not a substitute for building up international reserves, the Reserve Bank of Zimbabwe should address this aspect. Having usable international reserves below the standard 3-month threshold, there is a pressing need to build international reserves. For all intents and purposes funds in the SWF are savings for future generations. While savings in the SWF can be utilised for stabilisation, they are not as readily accessible as usable international reserves to meet immediate BOP needs. In any case the SWF Act of Zimbabwe does not explicitly state that one of objectives of the SWF is to meet immediate balance of payments needs. Essentially, the stated objectives of the SWF are stabilising fiscal revenues, meeting developmental objectives and providing savings for future generations.

Secondly, the initial conditions under which Zimbabwe has set-up the SWF are characterised by high debt over-hang; binding fiscal space constraints and balance of payments deficit. In this regard the Government's economic policy and legislative reform initiatives; debt and arrears clearance programme and doing business reforms have a positive bearing to the successful implementation of the SWF. Other country experiences like Botswana and Norway have shown that the growth of the SWF was propelled by sound macroeconomic environment with fiscal and balance of payment surpluses.



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The Zimbabwean context, for setting up the SWF can be viewed as a conscious strategy to induce a culture of public saving and fiscal discipline that will ensure that a portion of mineral revenues are harnessed and invested through a SWF. It has been observed by some stakeholders that with the current fiscal space challenges it may not be feasible to meet the 25% of royalties outlined in the Act. In this regard the initial amounts from the fiscus maybe small but what is important is establishing the principal and the institutional framework that will make it easy to scale up as conditions improve. Zimbabwe has already adopted debt and arrears clearance strategy and the proposed comprehensive reforms which if successfully implemented should reduce debt to sustainable levels and provide relief on the binding fiscal constraints. However, such strategy is only viable when (1) returns on the SWF are higher than the interest rate being charged on the sovereign debt; (2) the government does not renege on its commitments set out in the Zimbabwe Debt and Arrears Clearance Strategy. The viability of this strategy can be bolstered through implementation of deeper reforms anchored on the achievements of in the IMF staff monitored programme and (3) the Board explores innovative funding strategies to nurture the growth of the SWF.

Thirdly, leveraging on the abundant mineral resources to build a SWF requires government to put in place policies and programmes to boost value added mineral exports; and improve transparency and accountability in the management of natural resources revenues. This can be achieved by formulating enforceable fiscal rules that ensure that some resource revenues are saved in a SWF rather than used to meet current consumption. The SWF helps to transform exhaustible resources into financial assets or growth enhancing infrastructural assets that support the economic transformation of the country.

With regard to formulating a viable fiscal rule, lessons should be drawn from the experience of Chile (see Box 2) which has been able to design a fiscal rule using a price reference of copper that is counter-cyclical and has withstood the test of time.

Fourthly, the Government should adopt economic measures of performance other than GDP or GNI that take into account depletion of natural resources, namely: the adjusted net income measure, the adjusted net savings measure and the adjusted net operating balance metric. The adjusted net national income yields a true measure of income and is generally lower than GNI. The adjusted net savings measure yields a true measure of wealth creation after accounting for investment in human capital, depletion of natural resources and pollution damage.

For the Government to obtain a true measure of its fiscal stance and assess fiscal space, it is necessary to include in the accounting system the computation of the adjusted measure of the operating balance. The adjusted net operating balance which takes into account the depletion of mineral resources provides the most comprehensive measure of the government's fiscal stance where fiscal revenues from taxing of natural resources are substantial as is the case with Zimbabwe. The current accounting system that the Government follows treats the depletion of natural resources as volume change rather than as capital consumption. As a result the depletion of natural resources has no impact on the measured operating balance for government operations. The Ministry of Finance and Economic Development should seek technical expertise from the IMF in the implementation of these economic measures of performance. Implementation of these economic measures of performance may require deliberate programmes to build and sustain capacity which can be developed with technical assistance from development partners like the AfDB, World Bank and IMF.

Fifthly, the Government should streamline the levels of mining fees and charges to levels that promote the competitiveness of the sector and harmonise systems of agencies that collect mineral revenues. High fees and charges that are not comparable to the country's regional counterparts increase the cost of investment, impede new investments and sterilise mining ground. Government needs to expedite the development of a new mining fiscal regime that seeks to enhance the contribution of the mining sector by ensuring accountability and transparency on the part of government and mining companies. The mining fiscal regime also needs to balance the various fees and taxes being paid by the mining sector and the operational viability of players in the sector while at the same time encouraging new investment in the sector.

## RECOMMENDATIONS ON STRENGTHENING THE SWF ACT AND IMPROVE ITS IMPLEMENTATION

The Sovereign Wealth Fund of Zimbabwe Act lays out legal, governance and institutional arrangements which are generally consistent with the GAPP better known as the Santiago Principles governing SWFs. They emphasise appropriate governance, accountability arrangements and prudent, commercial investment activity. They also provide guidance to countries establishing, or considering establishing a SWF. The SWF Act explicitly subscribes to the Santiago Principles by restating them in the Third Schedule of the Act. In this regard the paper noted

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a few areas in the Act that may need to be reconsidered and suggested the following recommendations to address its shortcomings and strengthen the Act.

- (a) The Act should be easily accessible to the public in accordance with Section 16 for public disclosure. The Board can achieve this by creating a website accessible to the general public.
- (b) Section 11 of the Act can be relooked in light of the discretionary powers given to the Minister to give direction to the Board which can be viewed within the context of GAPP as interfering with the operational independence of the Board. The GAPP 6 states that once an investment mandate is given to the SWF Board, Government should neither direct nor interfere with Fund investment decisions, but leave the Board to account for overall portfolio performance.
- (c) The Act should provide a rule on how much can be withdrawn from the SWF for purposes of closing a budget deficit. Good practice requires withdrawal rules to be closely linked to the government budget surplus/deficit, and the amount to be determined as part of the annual budget process or pre-agreed rules. Furthermore, there should be specific mention of what exactly can be withdrawn – i.e. is it from the Fund’s capital or withdrawals are strictly restricted to interest accruing to investments made by the Fund’s management.
- (d) The Act should explicitly provide for the establishment of a Future Generations Fund among the segregated accounts of the Fund mentioned in Section 15. This would be consistent with Section 4 of the Act that states one of the objectives of the Fund as “to secure investments for the benefit and enjoyment of future generations of Zimbabweans”.
- (e) The Act should provide criteria for allocating resources among the segregated accounts of the Fund.
- (f) The Act should not explicitly specify the types of assets that the Fund should invest in. This should be decided by the Board and embodied in the Investment Policy which would allow flexibility required for the investment strategy to respond to changes in market conditions to meet the objectives of the SWF.

## RECOMMENDATIONS FOR ADDRESSING CAPACITY TO MANAGE RESOURCES AND THE SWF

The SWF is a new institution in Zimbabwe and inevitably there may not be adequate human capital with the capacity and experience in managing a SWF. In this regard government with support of development partners like the AfDB should undertake a capacity building programme for staff of the SWF. The objective would be to build capacity for a strong public investment management system to safeguard the quality of public investments financed by resource revenues. This can also be achieved through collaboration with institutions like the Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI) which is developing a Natural Resources Management Capacity Building Programme for the MEFMI region (MEFMI NRM-CBP).

Furthermore, the Government at an appropriate time can consider joining the IFSWF to benefit from the body of knowledge and sharing experience with other member countries in managing SWFs. This will also benchmark the country's SWF and subject it to voluntary reviews that enhance its systems as it strives to adhere to the Santiago principles which are considered as a barometer for best practices. The SWF Board can explore the merits, demerits and timing issues as they lead this process.

## LONG-TERM POLICY CONSIDERATIONS

Finally, cognisant of the exhaustibility of natural resources, in the long-run the Government should ensure that the following factors generally accepted as sources of growth are in place:

- Stability-oriented and competitiveness enhancing economic policies;
- Flexible and competitive product markets;
- Increasing valued added manufactured exports and promoting a high degree of exposure to foreign trade;
- Flexible labour markets;
- Leveraging on the investment in education and training;
- Simplified tax system and broadened tax base;
- Sustaining and business and investment friendly environment;
- Improving public spending on growth enhancing infrastructure development and research and development;
- Fostering increased value addition and beneficiation and strengthening of value chains; and
- Development of robust capital markets.

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While Zimbabwe is currently facing some binding fiscal constraints, a policy mix that leverages on the country's natural resource endowments through good management of the natural resources and that promotes the above factors is critical to long-term growth. A growing economy with broadening revenue base will create a fiscal environment that allows the growth of the SWF without undue pressure to prematurely withdraw funds from the SWF.

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# APPENDICES

## APPENDIX I: SWFs GENERALLY ACCEPTED PRINCIPLES AND PRACTICES –“SANTIAGO PRINCIPLES”

GAPP 1. The legal framework for the SWF should be sound and support its effective operation and the achievement of its stated objective(s).

GAPP 2. The policy purpose of the SWF should be clearly defined and publicly disclosed.

GAPP 3. Where the SWF’s activities have significant direct domestic microeconomic implications those activities should be closely coordinated with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies.

GAPP 4. There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF’s general approach to funding, withdrawal, and spending operations.

GAPP 5. The relevant statistical data pertaining to the SWF should be reported on a timely basis to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets.

GAPP 6. The Governance framework for the SWF should be sound and establish a clear and affective division of roles and responsibilities in order to facilitate accountability and operational independence in the management of the SWF to pursue its objectives.

GAPP 7. The owner should set the objectives of the SWF, appoint the members of its governing body (ies) in accordance with clearly defined procedures, and exercise oversight over the SWF’s operations.

GAPP 8. The governing body (ies) should act in the best interest of the SWF, and have a clear mandate and adequate authority and competency to carry out its functions.

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GAPP 9. The operational Management of the SWF's should implement the SWF strategies in independent manner and in accordance with clearly defined responsibilities.

GAPP 10. The accountability framework for the SWF's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or Management agreement.

GAPP 11. An annual report and accompanying financial statement on the SWF's operations and performance should be prepared in a timely fashion and in accordance with the recognized international or national accounting standards in a consistent manner.

GAPP 12. The SWF's operations and financial statements should be audited annually in accordance with recognized International or National auditing standards in a consistent manner. <sup>17</sup> <http://www.iwg-swf.org/pubs/gapplist.htm>

GAPP 13. Professional and ethical standards should be clearly defined and made known to members of the SWF's governing bodies, management and staff.

GAPP 14. Dealing with third parties for the purpose of the SWF's operational management should be based on economic and financial grounds, and follow clear rules and procedures.

GAPP 15. SWF's operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate.

GAPP 16. The governance framework and objectives, as well as the manner in which the SWF's management is operationally independent from the owner, should be publicly disclosed.

GAPP 17. Relevant financial information regarding SWF should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in incipient countries.

GAPP 18. The SWF's investment policy should be clear and consistent with its

defined objectives, risk tolerance, and investment strategy, as set by the owner or the governing bodies, and based on sound portfolio management principles.

**GAPP 19.** The SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with the investment policy, and based on economic and financial grounds.

**GAAP 20.** The SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.

**GAAP 21.** SWF view shareholders ownership rights as a fundamental element of their equity investments' value. If a SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protect the financial value of its listed entities, including the key factors guiding its exercise of ownership rights.

**GAAP 22.** The SWF should have a framework that identifies, assesses, and manages the risk of its operations.

**GAPP 23.** The assets and investment performance (absolute and relative to benchmark, if any) of the SWF should be measured and reported to the owner according to clearly defined principles and standards.

**GAPP 24.** A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the SWF.

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## APPENDIX 2: SWF BOTSWANA STUDY TOUR SUMMARY, 11 – 14 OCTOBER 2015

ZEPARU researchers and representatives of the Ministries of Finance and Economic Development and Mines and Mining Development undertook a study tour on 11 – 14 October 2015 to interrogate how Botswana set up and manage the Pula Fund. The case study of Botswana's SWF is particularly relevant to Zimbabwe for several reasons. First, the Pula Fund is one of the oldest African SWFs and well established. Second, it is among the only three African SWFs that subscribe to the Santiago Principles. Furthermore, according to the Linaburg-Maduell Transparency Index compiled by the SWF Institute, the Pula ranks highest among the African SWFs. Third, Botswana is one of the only three African countries (that include Angola and Libya) that have joined IFSWF, a voluntary group of SWFs which meet to exchange views on issues of common interest and facilitate an understanding of the Santiago Principles and SWF activities. Fourth, most African SWFs have adopted investment strategies that emphasise on liquidity and hence mainly invest in short-term, liquid government securities and money market instruments while the Pula Fund has invested 59% of its assets in bonds and 13% in cash and restricts its investments to rated assets according an AfDB study. Hence, it has a relatively long-term view towards investments to offer meaningful lessons. Fifth, the Bank of Botswana is the custodian of the SWF and the SWF of Zimbabwe Act designated the Reserve Bank of Zimbabwe as the custodian of the SWF, and hence there are lessons to be drawn from a further study of the case of Botswana.

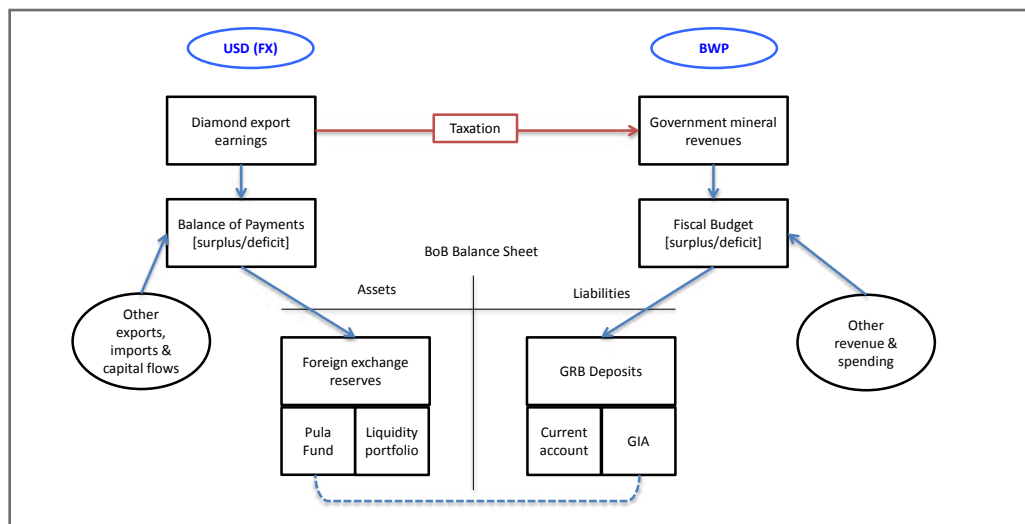
### SETTING UP AND MANAGEMENT OF THE PULA FUND

When Botswana started exporting too much diamonds in the early 1980s, the budget moved into surplus due to the balance of payments surpluses. Generally, the country has been running two surpluses, the budget surplus and the balance of payments surplus which resulted in foreign exchange accumulation, merely due to fiscal discipline. The Pula Fund was then established in 1993 under the Banking Act of 1975 and was subsequently amended by the Banking Act of 1996 which gave legal foundation for its management. The Pula Fund is not strictly a SWF.

The Pula Fund was established with fiscal rules of accumulating budget surpluses. The Pula Fund is not an independent entity, it consists of two accounts, the Government Investment Account that belongs to the Government of Botswana

and a foreign exchange reserve account that belongs to the Bank of Botswana (Figure 5). The national development plans determine how resources are going to be used over the medium term-usually 5 years.

Figure 5: Financial Flows: Pula Fund and Government Investment Account



Source: E-Consult

The Ministry of Finance is responsible for the overall fiscal policy and the Bank of Botswana manages the Pula Fund on behalf of the Ministry. The Bank of Botswana comes up with the guidelines for investment and the investment strategy. It also reports and audits the Pula Fund annually. There is a Board that oversees the Pula Fund, and sets the overall investment strategy.

The Investment Committee reports to the Board through the governor of Bank of Botswana on what has happened to assets managed by the Bank and those managed by fund managers. There is a Chief Internal Auditor who audits investments made in the Pula Fund and also reports to the Board. External Auditors audit investments from the Pula Fund and also report to the Board. The reports from the Board go to the Parliament through the Minister of Finance. Representatives of the Bank of Botswana answer to a specialised Parliament committee on public enterprises. After going through the specialised Parliament Committee, the Bank of Botswana has a detailed briefing with the President and Cabinet members. A meeting is also held to explain the position of the Pula Fund to senior government officials, the media, academia, researchers and the private sector.

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It was cited that the SWFs in countries like Singapore and Norway, are independent entities. Botswana had considered all options before settling for the arrangement of Bank of Botswana to manage the Pula fund since it is less costly.

## PURPOSE OF THE FUND

In principle, the Pula fund provides for current budget, a stabilisation buffer and a long-term savings fund for future generations. Total foreign exchange reserves are worth about P84 billion, of which P43 billion are government reserves.

Although the Pula Fund has been used to stabilise revenues and to save for future generations, its policy objective is unclear.

## FISCAL RULES FOR DRAWDOWN OF THE FUND

Despite having no explicit rules, there is an institutional mechanism with principles which officials operating the Pula Fund abide by. Fiscal rules are contained in the national development plans, some of which include the fact that all mineral revenue should be used for investment rather than consumption, the country should not borrow more than 40% of its GDP. The Government withdraws from the Liquidity Fund for cash flow purposes. In the past Botswana have withdrawn from the Pula Fund during the 2008-2011 global financial crisis.

There are no rules on what is spent or saved although there are rules for recurrent and capital expenditure. The Government expenditure should not exceed 40% of GDP (70% recurrent of total budget and 30% capital expenditure) and reserves should be equivalent to 6 months import cover.

The rules (public finance act) were developed even before Botswana had too much surpluses. On how much should be invested in the Pula Fund, the country puts aside foreign reserves that are equal to 6 months import cover and any excess is invested in the Pula Fund. The Bank of Botswana advises on the size of the Liquidity Fund, which is then agreed through a consultative process and the residual goes to the Pula Fund.

The Parliament has power to approve a budget that can draw on all reserves, which is a weakness of the fund. There are no rules about drawdowns. Further, there is no demarcation of how much Government reserves can be spent on current spending, stabilisation or a drawdown on savings for future generations. This is despite the fact that it is critical to earmark a proportion required for

the current budget, stabilisation buffer and the long-term savings for future generations.

## MODES OF INVESTMENT

The key principle in place is that of sustainable budget which requires all mineral revenues derived from depletable mineral revenue to fund human capital, financial investment and physical investment. For the last 40 years these rules have been adhered to and the distribution of assets is as follows:

- 45% has gone to physical infrastructure;
- 45% for human education, training and health and
- 10% to financial assets.

## THE GOVERNMENT FINANCIAL ASSETS ARE ABOUT 30% OF GDP

Investment for the Pula Fund is 100% offshore. The country has done very well in terms of taxing mineral rents through profit taxes, withholding taxes, royalties and equity stakes. A consultant in London works on the expected return through various asset combinations, and once agreed upon it then goes into the investment strategy. An Investment committee guides the process and this committee meets every 4 weeks to decide the investment mix (i.e. how much should be invested in US dollar, Yen etc.) based on developments on the international market.

Botswana's Income Tax Act offers variable tax rates to different companies based on their profitability. Neither the Ministry of Finance nor Ministry of Mines can vary the tax rate. Ministers only have power to defer royalties to a group of miners (not individual miners). For instance, copper miners can be granted a deferment of royalty payments due to low international prices obtaining in the global market. Individual companies cannot strike special deals. The Pula Fund is not used for recurrent expenditure (except for human capital investment).

## SKILLS AVAILABILITY

A SWF is skills intensive which requires internationally competitive remuneration and worse still, the skills are not readily available in Botswana. When employing fund managers, the Bank of Botswana works with an entity based in London to select potential fund managers through a competitive process of interviews. The selected candidates are recommended to the Pula Fund Board which makes the final selection. Two times a year, fund managers report on how the assets they are managing have performed. There is no permanent fund manager. The Fund Manager's performance is reviewed from time to time. If they do not perform according to expectations they can be relieved of their duties anytime.



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## DISCLOSURE

The Bank of Botswana reports on the Pula Fund in its Annual Report which is available on the Bank of Botswana website.

## IFSWF MEMBERSHIP

Botswana is a founding member of the IFSWF. The purpose of joining such a forum is to have peer review. The 2014 Report of the IFSWF has 15 case studies including that of Botswana. On the international ratings, Botswana is not scoring well in terms of rules and transparency. However, it was noted that there is high level of disclosure.

## LESSONS FOR ZIMBABWE

Botswana's mineral policy is that all minerals belong to the state but private investment is allowed. Income taxes, dividend paid to government and royalties by those who exploit the resources go to the Pula Fund. The Ministry of Minerals, Energy and Water Affairs has a Mineral Policy Committee, which comprises permanent secretary to the cabinet, permanent secretaries of Ministries of Minerals, Energy and Water Affairs and that of Finance, and the Attorney General. The Mineral Policy Committee negotiates the rates of taxes and royalties and recommends to cabinet. The Income tax act has the rates of taxation for every sector but for diamonds there is a special negotiation outside of the Income tax. The Ministry of Finance is working on fiscal reforms on how much can be put in the fund and how much can be withdrawn.

Botswana is now undertaking beneficiation of diamonds which started around 2010 and since then it has been importing raw diamonds from other countries such as South Africa and Namibia for processing. All revenues accrue to the Bank of Botswana, which keeps both the government accounts and the Pula Fund. When Botswana borrows, the money does not go to the Consolidated Revenue Account but to the Development Account.

The government is able to closely monitor diamond revenue since it has a 50% stake in the largest diamond mining company, Debswana and the other 50% is owned by De-Beers. The Government has Board representation which enables interrogation of financial statements. When the mining lease expires, the Government renegotiates with De-beers and they stick to the agreements. Botswana government hires international legal experts and mining engineers to

represent them on the negotiating table, putting them on a good negotiating position.

With reference to Zimbabwe, other key facets when setting up a SWF were noted as follows:

- The notion of running budget surpluses - most countries with SWF do not have large debt burden. Hence for Zimbabwe priority should be to pay off the debt before accumulating funds in the SWF.
- Spending on projects has to go through the budget
- Nigeria experience on the drawdown of almost all financial resources in the SWF may be due to failure to follow set rules.
- Given that Zimbabwe is not running budget surpluses, it is difficult to save financial resources to fund the SWF given that the country is facing very limited fiscal space.

There were media reports when the research team visited Botswana that government was considering to drawdown the Pula Fund in the near future to stimulate the economy through employment creation. The study team did not have access to investment policy documents. However, officials it met indicated that the Pula Fund has largely worked well because of prudent policy making and fiscal discipline exercised by their political leaders.

It was highlighted that the Pula Fund has not been used as collateral since there has not been need to borrow in the past but it is an option that can be considered in future when the need arises.

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