Sovereign wealth failure?

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Most scholars writing on sovereign wealth funds (SWFs) agree that countries create SWFs for one of three reasons. The first reason is to hedge against commodity price volatility. Countries particularly dependent on the export of a certain natural resource tend to invoke this reason in creating SWFs. The second reason is to diversify away from cash holdings or low-yielding U.S. Treasury bills. For this reason SWFs may be attractive to countries that build large amounts of international reserves. Third, a country may choose to create a SWF as a savings vehicle to save today's wealth for future generations while foregoing current day consumption.

Of course these goals are not mutually exclusive. There are SWFs that serve two of these purposes at the same time, or are subject to a mandate change after having been established. Norway's SWF began as a dual-purpose fund designed for hedging and saving, then drifted toward serving the sole purpose of saving revenue from Norway's exploitation of oil and natural gas reserves. In fact, debate in Norway over the mandate of the SWF, and the date at which the government will taper savings, has become so politicized that it is seen to have contributed to the change of government in Norway's 2013 election.

Canada does not have this problem. The Canadian electorate does not face the issue of deciding whether our SWF is healthy enough that we should start consuming more of our current resource wealth. Our federal governments, past and present, have decided that saving the windfalls of our current production is not an attractive policy option and that future generations will have to find their own resources to exploit. This short essay is not a critique of the current government's stance on managing Canada's resource wealth; rather, it outlines how over the last three decades successive Canadian governments have avoided the hard and, some would argue, responsible path to proper fiscal management of our natural resource wealth. Governments have chosen this path while other countries with similar macroeconomic structures make different, politically risky decisions to introduce SWFs in the interest of sound long-term economic management. While the division of powers among the Canadian federal government and the provinces presents a different challenge than some of these other cases, the fact remains that these other governments were able to overcome impediments to SWF creation while the Canadian government was not.

What leads a country to create a SWF?

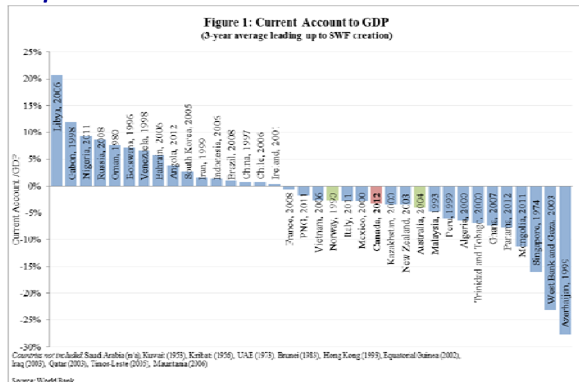
The existing SWF literature points to macroeconomic conditions common among SWF-having countries in order to identify drivers of SWF creation. Specifically, scholars have found that countries with chronic current account surpluses, or high proportions of fuel exports to total exports, or significant international reserves, are more likely to have a SWF. These same scholars then posit that these countries are motivated to create a SWF as a way to address the vulnerabilities and/or opportunities that accompany their macroeconomic conditions. Other recent research indicates that it is not just macroeconomic conditions that may be motivating SWF creation, but that some countries, fuel exporters in particular, create SWFs as a way to emulate the policies of other fuel exporters. Essentially, that one country sees another country employing a

SWF to hedge the price risk of their commodity production and follows suit.

Does Canada fit the macroeconomic profile?

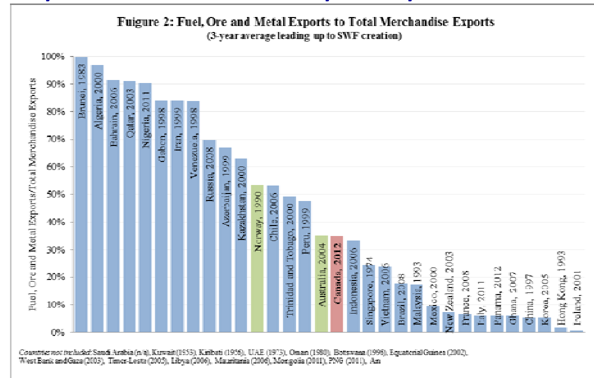
According to the SWF Institute, there are currently 45 countries that have SWFs.[1] Some of these SWFs are large, with over $500 billion in assets, while others are small, with less than $1 billion. The following three graphs show Canada's position among these 45 countries with respect to macroeconomic conditions. To make for a more accurate comparison, the data for SWF-having countries and Canada are averages of the figures in the three periods leading up to SWF creation, with Canada's averages derived from the 2009 to 2011 period.

Graph 1: Current Account Levels



In the above, it is apparent that of the 36 SWF-having countries for which there is current account data, more than half were averaging current account deficits in the years leading up to creation. If the nine countries not included had current account surpluses prior to creating SWFs, the number of SWF-having countries with current account surpluses would increase to slightly more than half of the total population. Countries such as France, Norway, Italy, Mexico, New Zealand and Australia are in this category. They all were averaging current account deficits, but still had the desire to implement a SWF. Those who argue that Canada should wait until the current account balance shifts to a surplus before instituting a SWF should consider these cases.

Graph 2: Fuel and Mineral Export Dependence



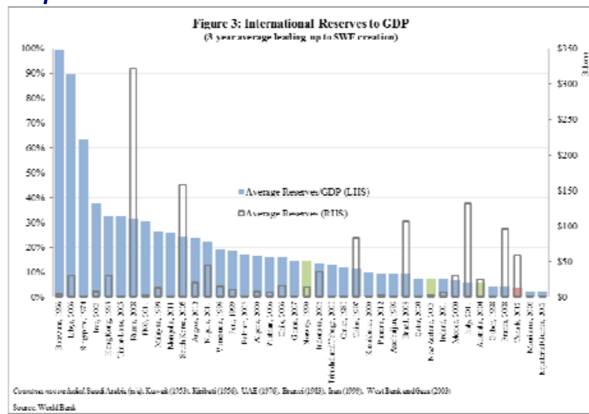
As with current account to GDP figures, Canada's most recent levels of dependence on fuel and mineral exports are close to the median levels of SWF-having countries. While the SWF literature focuses on fuel exports as an explanation for a country's desire to create a SWF, examples such as Botswana, Chile, and Peru show that export dependence on other resources, such as diamonds, copper, and gold can be similarly important in motivating SWF creation. It is also important to keep in mind that unlike many of the countries more reliant on fuel and mineral exports, Canada has a relatively diverse export profile in goods and services. Canada does not fit the profile of the 16 SWF-having countries shown above that rely heavily on fuel and mineral exports.[2] Canada is less reliant on fuel exports not because it exports less oil than these other countries, but because Canada's oil exports comprise a smaller percentage of its total exports, which include merchandise and other goods. This distinction is important to note when considering the fact that Canada is the only

[1] This number does not include Canada and the United States whose provincial and state funds have no linkage to the national government.

[2] The number of countries more reliant on fuel, ore and metal exports would have been higher if data would have been available for all countries with a SWF.

country of the 15 largest oil exporters that does not have a national SWF.

Graph 3: International Reserves



The most compelling argument against a Canadian SWF from a macroeconomic perspective is the fact that Canada's international reserves as a percentage of Canada's GDP is lower than the average ratio of international reserves to GDP held by SWF-having countries. It is also important to note that if Canada had created a SWF in 2012, its three-year average GDP leading up to SWF creation would have trailed only Russia's average leading up to its 2008 SWF creation and France's leading up to its 2008 SWF creation. Canada's actual amount of international reserves more closely aligns with those of countries that have created SWFs. Given the fact that Canada's currency floats and that the government can borrow easily thanks to our good credit rating, the pressure for Canada to build international reserves is relatively low. Without the need to intervene in currency markets to protect a fixed exchange rate, Canada is able to hold less in international reserves and employ these funds for other uses.

Could Canada have been Norwegian?

Norway's Government Pension Fund Global (GPFG) surpassed a market value of $744 billon USD in the first half of 2013. The fund garnered a 5.5% return during the first six months of 2013 and has returned over 12% in the past twelve months.[3] Despite its name, the GPFG is not a pension fund in the same sense that the Canadian Pension Plan is a pension fund, as the GPFG has no formal current liabilities, while the *Canadian Pension Plan Act* spells out its relationship to Canadian citizens. This absence of current liabilities is the defining feature separating government pension plans from SWFs, regardless of the names governments have chosen for their SWF.

The mandate of the Norwegian SWF has changed since the fund's inception in 1990. As the GPFG became bigger, its role in buffering the Norwegian economy from commodity price swings was dropped from its mandate. The fund now serves the single purpose of saving revenue from Norway's oil and gas resources for future generations. Given that Norway's fuel exports over the past ten years have made up almost 65% of its merchandise exports, it is possible that if oil and natural gas prices plummet, the Norwegian government will tap the GPFG; however, such a scenario seems unlikely given the fact that the Norwegian government has averaged an annual budgetary surplus of 10.28% of GDP since 2003.

Should Canada have followed the Norwegian path to a SWF? While Canada had been less dependent on fuel and mineral exports than its Norwegian counterpart, the rents accumulated from harvesting oil, natural gas, and mineral resources had been far more lucrative in Canada than in Norway prior to 1990 (the year that Norway established the GPFG). As well, it is important to note that even though the GPFG was established in 1990, it was funded only in 1996. This is due to legislation that required a government budget surplus to fund the GPFG. If Canada had followed this model of waiting for a government budget surplus to fund a SWF,

[3] This figure is net of management costs and inflation.

the federal government would have been in a position to introduce to a SWF in 1997. The Canadian government decided to pay down the national debt with these surpluses—a reasonable policy, though a questionable one, considering the current value of the Norwegian GPFG.

Maybe not Norwegian, but Australian?

In 2006, the Australian government sought to strengthen its long-term financial position by creating the Australia Future Fund. The Future Fund is interesting in that its mandate is to make provision for future, currently unfunded, superannuation liabilities that will become payable as the Australian population ages. What differentiates the Future Fund from a traditional national pension fund scheme like the Canadian Pension Plan is the fact that the Future Fund has no current liabilities (i.e. it does not currently pay pension recipients), but is also not funded by future recipient contributions. The Future Fund, like Norway's GPFG, is funded by government budget surpluses. The Australian government has only made three contributions to the fund from these surpluses. The first contribution, the original seed money, amounted to $18 billion in 2006. The other two contributions occurred in 2007 and totalled $10.6 billion. The 2007 contributions from the government came from the privatisation of Telstra (a telecommunications and media company).

According to its 2012-2013 annual report, the Future Fund has grown its $60.5 billion in contributions to almost $92 billion (6.4% average growth per annum). This growth is particularly significant when compared to global investment benchmarks like MSCI World Index, which report that global equities earned 12.4% (1.7% average growth per annum) over the same 2006 to 2013 period.

The comparison between Canada and Australia is striking. From the Figures 1, 2, and 3, it is evident that Canada and Australia are quite similar in all three macroeconomic conditions that typically lead a country to create a SWF (current account balances, fuel and mineral export dependence and international reserve balances). As well, Australia's federal system, which includes equalization payments among Australian states, is similar to Canada's. Both countries face the perennial problem of unequal economic development across a large land mass. The province of Western Australia, which accounts for 46% of Australian exports and almost 15% of Australian GDP, bears similarity to Alberta, which accounts for 21% of Canadian merchandise exports and almost 17% of Canada's GDP. The Premier of Western Australia, Colin Barnett, has announced that Western Australia plans to create a state SWF to invest the proceeds of its iron ore and mineral extraction activities. Although Alberta created the Alberta Heritage Fund in 1976, this fund has remained small and stagnated despite more aggressive extraction practices.

Why not Canada?

In 1976 the Lougheed government of Alberta established the Alberta Heritage Fund with three objectives: to save for the future, to strengthen or diversify the economy, and to improve the quality of life of Albertans. Originally conceived to accumulate 30% of non-renewable resource royalty revenues, the Heritage Fund stopped receiving these contributions in 1987 as the provincial government decided that royalty revenues should be included in the general revenue of Alberta's government budgeting. This decision was based on the idea that reducing the budgetary deficit while continuing to provide a certain level of government services was more important than directing resource revenues solely to the Heritage Fund. At the time of the decision, the Fund had received over $12 billion in contributions. As of 2013, the Heritage Fund

has retained $4.6 billion of the $33.4 billion in accumulated income it has produced since 1976, while the Alberta provincial government has racked up an $8-billion provincial government surplus.

This is not to cast a negative light on the Alberta Heritage Fund. Many who study SWFs laud the fund's transparency and the Alberta Investment Management Company's rate of returns. Nevertheless political issues surround the fund. Why stop funding the Heritage Fund, when it has the potential to grow beyond its current $16.8 billion? Before his death, former Premier Lougheed estimated that Alberta government had put 30% of resource revenues into the Heritage Fund, it would be now worth over $100 billion. Furthermore, by allocating the annual income accrued to the general revenue of the Alberta government, the real value of the Heritage Fund has decreased through inflation of the Canadian dollar. Had the Heritage Fund not received any more contributions, and had the government refrained from tapping the funds' assets, its value today would be $21.6 billion. In essence, by raiding the fund, Alberta's recent provincial governments have not only neglected to save for the future but have eroded savings made by prior governments.

The lesson from Alberta is this: long-term fiscal responsibility planning isn't as sexy as a tax cut, especially when there is little guarantee that successive governments will stick to a previous government's fiscal plan. Even in Alberta, where Premier Lougheed was succeeded by four consecutive leaders from his own party, governments lacked the political will to save for the future. This uncertainty, combined with the fact that most other provinces and territories have accumulated large debts, makes the idea of spreading resource wealth unappealing. Furthermore, with Canada's division of powers the way it is, the federal government taking a more active role in investing a province's resource windfall would no doubt be greeted with hostility. That being said, the data outlined above makes clear the fact that Canada is among a set of nations whose macroeconomic conditions facilitate the creation of a SWF. For those arguing against such a policy tool, one of two things must be true: either Canada's economy and political structure is unique and macroeconomic data does not capture the political economy impeding Canadian SWF creation, or the choice to create a SWF, made by 45 other countries, was misguided. The examples of Norway and Australia show that some among these 45 countries have made successful investments and that creating a SWF was a shrewd fiscal policy. As well, the example of Australia demonstrates that SWF-having countries have been able to overcome the challenges of a federal system. The only question remaining is that of the cost of Canada's lack of fiscal restraint on future generations.