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Analysis of the Draft Model of a Sovereign Wealth Fund presented by Central Bank of Mozambique

- It is necessary to guarantee effective Transparency and Mechanisms of Accountability in managing the Sovereign Fund for development (currently the most relevant for Mozambique)

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Context

Discussions on the need to create a sovereign wealth fund to manage the revenue obtained from the extractive sector in Mozambique go back for more than 6 years. The defenders of the creation of a sovereign fund for managing the revenues rest their case, in part, on the fact that the extractive resources are not renewable, and it is forecast that they will provide revenues far greater than those that are currently generated by the country's productive sectors, and which could cause disturbances within the national financial system. Thus, through a sovereign fund, managed within good international practices, it would be possible to guarantee that the resources generated in this sector benefit not only the current generation, but also future generations, and avoid an excess of liquidity for the Government.

It is expected that Mozambique will collect about USD 96 billion during the useful life of the natural gas exploration projects.[1] The main challenge consists of finding ways to maximise the gains arising from the revenues from natural gas and other non-renewable natural resources[2] and to develop functional and transparent institutions, without atrophying the economy.[3]

In this context, the Bank of Mozambique (BM) has presented a draft model of a sovereign wealth fund for Mozambique and CIP, in its capacity as an actor interested in seeing that the revenues from the extractive sector are not a curse on the country, and also that the model of the sovereign wealth fund that will be defined serves to attain the purposes for which it was created, and does not benefit only one group of Mozambicans, presents its comments for improving the draft presented.

1 National Petroleum Institute, 2019

2 Non-renewable natural resources refer to all mineral resources on the territory and in the sea of Mozambique, which become exhausted over time.

3 Draft Model of the Sovereign Wealth Fund for Mozambique available on the site. http://www.bancomoc.mz/

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Analysis

On the Objectives of the Fund

According to the document presented by the Bank of Mozambique (BM), the model of the sovereign fund proposed, which will be managed by the central bank, pursues two (2) objectives¸ namely:

a) **Savings -** through maximising the value of the fund in order to ensure that the revenues from the non-renewable natural resources are shared between several generations; and

b) **Fiscal stabilisation –** in order to isolate the budget and the economy from the damaging impacts resulting from the fluctuations in commodity prices on the international markets.

As for **Development**, the BM proposes that the revenues deriving from the exploitation of the resources should be channelled towards investment in infrastructures and managed by the Government through the Ministry of Economy and Finance via the State Budget (OE). The Assembly of the Republic will define how the resources are used, including the priority capital expenditure.

In general, the BM grants the MEF and the Assembly of the Republic the responsibility for one of the most important components of the sovereign fund, which is the development component. Mozambique is a developing country, with huge gaps in infrastructures, with a growing population putting pressure on the State to provide more services, and a high exposure to risks of natural disasters. These facts increase by the day the magnitude of the challenge facing the Government to guarantee sufficient good quality infrastructures able to satisfy the ever growing needs of the population. The 2019 World Bank report on the *"spatial inequalities in access to basic infrastructures in Mozambique"* indicates that Mozambique has a level of access and a quality of infrastructure far below that of other countries in the region (World Bank, 2019). (see graph below):

Graph 1: Quality of Infrastructures in Sub-Saharan Africa (2017)

Source: World Bank report, 2019

This scenario shows that this proposal is adequate to the current needs of the country, considering provision for future generations, vulnerability to external shocks and the deficit in infrastructures and other needs. However, it omits the percentage of the revenues that will be destined, on the one hand to stabilization and, on the other, to savings. Also missing is the presentation of technical arguments for allocating these percentages.

The definition of the percentages for each of the objectives can help forecast, with some precision, what sums will be available to the Government for confronting external shocks or disasters, as is envisaged in the draft, as well as the gains from the savings, some of which, it is believed, will be applied over the long term.

The model proposed mentions, as the main challenge for Mozambique, the management of the revenues derived not only from the exploitation of the natural gas and the mining sector, but from other non-renewable resources. This means that the sovereign fund will be fed by the revenue from exploiting resources such as natural gas, petroleum, minerals, water resources and others. This proposal does not make sense, since only the revenues from the exploitation of natural gas and mining, as shown in the justification of the draft, have the potential to generate distortions in the economy. Hence, this runs the risk of draining the attributes of the Ministry of Economy and Finance regarding the management of revenues. **This being the case, we propose it be specified that the sovereign fund of Mozambique will be fed by the revenues from the petroleum and gas sector and from the mining sector (if applicable).**

Given the condition of liquidity necessary in the act of investing the resources, the draft model of the Fund should include the timing to be observed in disbursing sums from the Fund to the OE, particularly in the case of the stabilisation fund, which is intended to provide for situations of shocks which cause a significant fall in revenue.

It is important to mention that countries which have adopted the sovereign fund as an instrument to manage revenue, such as the cases of Iran [4] and Norway[5], laid down as the source of financing for the Fund revenues only from the petroleum and gas sector, which have the capacity to generate distortions in the economy, and left aside other resources, even if considered non-renewable.

On the Structure of governance of the sovereign fund

CIP believes that the structure proposed for the management of the Fund is very minimal. It ignores the role of other relevant institutions or groups, such as the Attorney-General's Office (PGR), the Administrative Tribunal and civil society organisations. The structure for managing the Fund consists of the Assembly of the Republic (**legislator)**, the Ministry of Economy and Finance (**formulation of the investment policy and supervision of the management)** and the Bank of Mozambique (**operational manager)** which could manage part of the funds directly, and allocate part to internal and external managers whom it hires.

Apart from ignoring the role of other institutions, it does not take into account the political economy of the management of public finances in Moçambique, which should take into consideration the various actors involved in this process, their institutional and particular interests; the weaknesses and the fiduciary risks which are constantly indicated in the reports and opinions of the Administrative Tribunal, and also in the various denunciations presented by the media and/or civil society organisations, concerning the financial mismanagement of public assets.

Now, the management of the revenues deriving from the exploitation of non-renewable resources requires, more than any specific technical capacity, transparency in the management of the resources involved and efficient accountability mechanisms.

In accordance with the structure proposed, the MEF will have the task of managing the revenues for development, while the Assembly of the Republic (AR) will have the role of defining the use of the resources, including the priority investments.

Resorting to budgetary logic as the mechanism for managing revenues aimed at the development of the economy (with a focus on infrastructure) is like saying that the revenues should be managed in the same way that the MEF is managing the current resources, where all sums are channelled into the same "basket" (the Single Treasury Account) without rigour

4 https://www.ifswf.org/members/iran
5 https://www.nbim.no/

and without alignment with budgetary planning (based on cash flow) which contributes to the constant deviations in how funds are used.

Experience shows that lack of transparency in the management of public resources via the state budget is a constant. The reports and opinions of the Administrative Tribunal have revealed several aspects that constitute bad practices, among which the following stand out:

a) Deficiencies in the internal control of State bodies and institutions, expressed in situations such as: 1. Lack of availability, during the audits, of proof of the expenditure undertaken; 2. Payment of expenditure that is not eligible, in various investment projects; 3. Incorrect classification of expenditure, failing to observe the Economic Classifier of Expenditure, approved by Ministerial Diploma No. 221/2013, of 30 August, from the Minister of Finance; 4. Lack of proof, in the corresponding files, that the goods acquired have been received; 5. Reports/opinions of the independent inspectors did not exist in the files on the payment for civil construction jobs; 6. Lack of registration, in the 2018 CGE, of the execution of some projects with external financing, outside of the CUT. A defective system of internal control of State bodies and institutions compromises observance of the principles of cost-effectiveness and efficiency, advocated in Article 4 of Law no. 9/2002, of 12 February;
b) Violation of the norms on drawing up and implementing acts, as well as the assumption, authorisation or payment of public expenditure or commitments, which constitutes a financial infraction envisaged in paragraph 3, line (b) of Article 98 of Law no. 14/2014, of 14 August, in the wording given by Law no. 8/2015, of 6 October;
c) Running costs that are structurally higher than capital costs. From 2014 to 2018, running costs grew by 50.4% but capital costs shrank by 22.8%, which compromises the use of resources for the development of the country;
d) In the economic and social areas, there are differences, both in the budgetary allocation and in the respective execution, when the data contained in the General State Account are compared with those extracted from e-SISTAFE.
e) Financing of public companies with an unsatisfactory performance, such as Petromoc and Airports of Mozambique;
f) Trend of the public debt service to grow, both the internal debt service, which rose from 26.9 billion meticais in 2014 to 95.6 billion meticais in 2018 and the foreign debt service which grew from five billion meticais in 2014 to 15.2 billion meticais in 2018.

Hence CIP proposes that that the part of the fund with a development objective should be managed by an institution other than the MEF, which is independent, free from political pressure and endowed with strengthened internal control mechanisms. One of the reasons for this conviction is that the MEF is not immune to political pressure and, as such, a considerable part of the resources which it is proposed should be channelled to the OE could be used to meet electoralist pretensions, particularly in the final year of a government's term of office, to the detriment of investments that respond to the concrete needs of the country's development, An example of this is the case of the 2019 State Budget, in which the government forcefully increased by 100 per cent expenditure on the elections, and classified this as capital expenditure.[6]

Furthermore, CIP believes that the Ministry of Economy and Finance (MEF), responsible for the investment policy, should present, in a well-grounded manner, the investment policy, and this policy should be subjected to public consultation during a period of time which makes it possible for the various forces of society to contribute.

As for responsibilities, it is necessary to clarify which areas are the responsibility of the MEF and which are the responsibility of the BM. The draft presents the MEF as the body which will draw up the annual report of the Fund, while the BM draws up the quarterly performance reports. CIP believes this does not make much sense since the BM manages the Fund (savings and stabilisation) and thus this should be the institutions that draws up the annual report. The MEF should be responsible for drawing up the investment policy and the reports (monthly, quarterly and/or annual) on the use of the resources channelled to the OE for the development of infrastructures.

6 https://cipmoz.org/2019/03/31/orcamento-para-eleicoes-de-2019-e-excessivo/

Since the draft presents the BM as responsible for the Fund with savings and stabilisation objectives, there is no justification for the same body being responsible for implementing the investment policy and the technical guide. This responsibility should be given to the MEF.

As for the Assembly of the Republic, the indication that this is the body that will define the rules for the use of these revenues should be accompanied by a specific capacity building plan. The reason for this is that the Assembly has displayed a shortage of the technical instruments necessary to intervene in matters relating to the extractive industry. Hence CIP believes it would be important to include in the draft model of the sovereign fund the need to set up a thematic group within the AR which should be trained in order to guide the definition of the mechanisms for managing the revenue from the extractive sector destined for development, as well as to monitor the sums intended for savings and stabilisation.

This action would allow greater mastery, not only to approve the model with some awareness, but also for greater skills in inspecting the other stakeholders in the fund's management. The AR should play a greater role, so that, in addition to being the legislator, it is also an inspector.

On the rules for the entry of resources

According to the projection of revenue from the gas sector, it is expected that, in the first 20 years 50% (out of a total of USD 3.81 billion) will be channelled to the savings and stabilisation fund, about USD1.96 billion. It is expected that the same amount will be channelled to the OE. This sum corresponds to slightly more than 60% of the OE for 2019 and 2020.

The first aspect to bear in mind is that the draft does not present the technical arguments for the definition of the 50% of the annual revenue to be levied. These arguments should take into consideration the primary balance, the budgetary deficit (net of loans and grants) as well as the targets contained in the plan of action of the investment policy to be produced

The technical arguments are fundamental for monitoring the objectives defined, that is, whether they are really being achieved or not. The experience of setting a rate of 2.75% for transfers to the communities, without any explanation of the criteria used for its definition, should be regarded as an experience to be avoided, since it is not transparent.

It is necessary to be clear, for example, on what assumptions were used so that, as from the 21st year, the channelling of funds to the Government declines by 30%.

Considering the arguments presented by the BM, it is estimated that the Fund (savings and stabilisation) will reach its stage of maturity in the 20th year of its existence, according to the projections of the flow of revenues expected. CIP believes that the projections should have been published alongside the draft, to allow better analysis and transparency. Until then, it is expected that the State Budget will have greater financial autonomy and the capacity of the economy to absorb the financial resources from natural resources will be very small or limited. One of the arguments behind the creation of the Fund is the current incapacity of the economy to absorb large capital flows without creating distortions. This being the case, it cannot be justified that, as from this year, only 20% should be allocated to the OE and 80% (more than USD 3 billion) to the Fund. It is supposed both that the economy will have gained the capacity to absorb increasingly large flows of capital, and also that the Fund will have created sufficient reserves for its sustainability. **In this case, it is proposed that the greater part be channelled to the objective of development, and not for savings and stabilisation.**

A further relevant aspect that should be clarified in the draft is the fact that the Single Fund Account (CUF) will be set up in dollars. Considering that the taxes will be paid in meticais, this assumes the conversion of the revenues to dollars which could generate pressure on the national currency (depreciation of the metical), and will thus constitute an exchange risk.

CIP recognises the importance of constituting the CUF in foreign currency, as an instrument for avoiding Dutch disease, but we suggest that this conversion be undertaken with resort to only part of the value of the fund, and not all of it, thus ensuring that the margin intended for application on the domestic market, and to other applications in national currency will be exempt from this exchange risk.

On the rules for the exit of resources

The draft envisages payment of a fee to the BM for management of the Fund. CIP believes this fee should be defined in law, and not by negotiations between the BM and the MEF. It is also necessary to define, very clearly, what expenses this fee seeks to cover, in order to avoid discretionary expenditure in perks for the Fund managers and other non-productive purposes. It is also important to clarify the destination of the interest received in application of the fund. This information is not explained in the draft presented.

The draft, in lines b) and c) presents the conditions for the exit of resources for stabilisation of the economy, faced with the decline in revenues from the mineral resource extraction sector in the first 20 years of the Fund. CIP thinks it necessary to justify the definition of 10% as the minimum fall in revenue for an intervention and also the figure of 4% of the revenue collected in the immediately preceding financial year as the maximum revenue to be channelled towards stabilization.

As for line d), although the priorities had been defined in terms of the sectors that should benefit from financing from the Fund in the event of extreme events, it is thought necessary to mention that the distribution of this sum should take into account the magnitude of the damage caused by these extreme events.

The draft says that the Fund will reach maturity in the 20th year of its existence, and in the same period, the OE will have greater financial autonomy and the economy will have greater capacity to absorb the revenue from the resources. First, it would be important on this point, to present the projections made by the BM to allow the other actors to make a critical analysis of these projections. Second, line **f)** indicates that, as from the 21st year, 4% of the balance of the Fund ascertained at the end of the immediately preceding financial year will be channelled to cover the deficit arising from the fall in revenues, that is, from 50% in the first 20 years to 20% as from the 21st year. Once again, the draft should present the technical arguments for these figures and the bases to sustain that the fall of 30% in channelling to the OE, will be compensated for by the transfer of 4% of the balance of the fund from the immediately preceding year.

As for the use of funds to face a public disaster, arguments must be brought to define the figure of 2% of the balance of the Fund ascertained at the end of the immediately preceding financial year, considering that disasters have different impacts and needs. A further aspect deemed important to define for the good of transparency is the need to establish that it is obligatory for the AR to approve the use of funds for stabilisation of the economy and for disasters.

The BM draft does not mention what treatment will be given to that part of the taxes on production that should legally be channelled to the communities (currently defined as 2.75% of the tax on production).

As for transparency, the draft mentions that the quarterly and annual reports on the activities of the Fund should be made available to the public, but the preservation of confidential information should be guaranteed. However, it does not mention which categories are included under the term confidential information.

Proposal for Distribution of Resources

CIP proposes that the greater part of the revenue from exploiting the resources should be channelled to the development fund on a growing basis, considering that the economy will have increasing capacity to absorb revenue, as shown in the table below.

	Up to 20th year	**From 21st to 30th**	**As from 31st year**
Development Fund	50%	70%	80%
Savings and Stabilisation Fund	50%	30%	20%

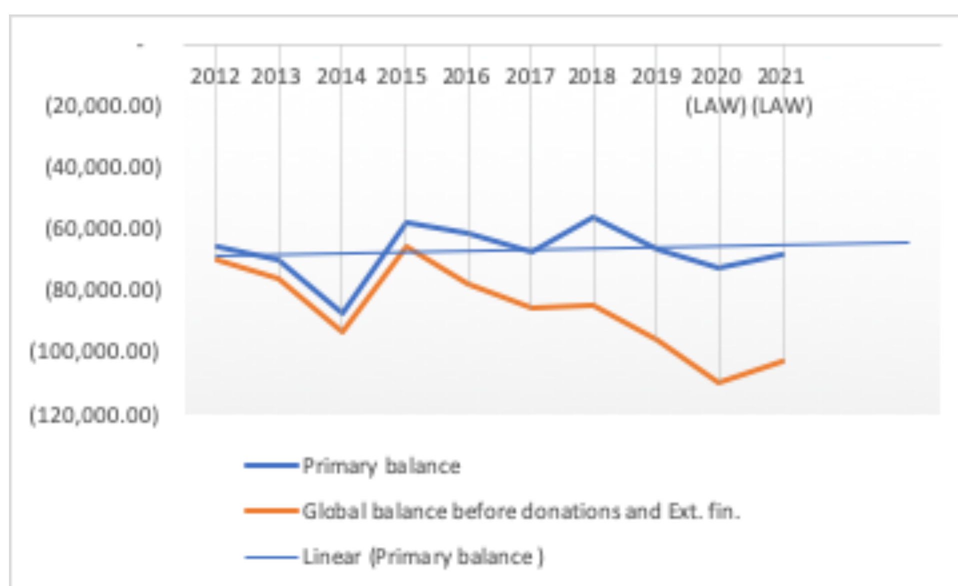
The justification for the first period is the average value of the primary deficit for the last ten years together with the

Bank's claim that the Savings and Stabilisation Fund will reach maturity in the 20th year.

Currently, the primary deficit is about 1.4% of GDP in the 2020 State Budget, and it is expected to fall to 0.6% of GDP in 2023¸ as forecast in the MEF's 2021 Report on Fiscal Risks.

According to data from the CGE (2012-2019), the OE (2020) and the draft OE (2021), the Mozambican economy showed lack of capacity over the 2012-2021 period to mobilise fiscal and non-fiscal resources to reduce the budget deficit. This scenario can be seen from the evolution of the primary deficit which rose from about 65 billion meticais in 2012 to a forecast of about 68 billion in 2021, a growth of about 9%. On average, in this period the primary deficit is about 67 billion with a tendency to grow at about 2% a year. It should be mentioned that, in 2020, the deficit grew to about 72 billion (a sum above the average) associated with the negative effects of the Covid-19 pandemic on the economy. The situation of 2020 is an experience that should be taken into consideration since the fund envisages the use of its resources to deal with this sort of situation. Hence, a greater allocation of funds to development could reverse this scenario. Se the graph below, which shows the primary balance in millions of meticais between 2012 and 2021[7].

Graph 2: Evolution of the primary balance in millions of MT (2012-2021)



Source: calculations by the author based on data from the CGE (2012-2019) and OE (2020-2021)

Note: the rates proposed could undergo alteration, as long as they remain on the same trajectory of the funds presented, taking into account the target to be set in the plan of action of the investment policy to be drawn up by the MEF and which will be subject to public consultations by the interested institutions.

Final considerations

The draft model of the sovereign fund for Mozambique presented by the BM is an important basis for public discussion on the type of fund that Mozambique wants to make operational for inclusive and transparent management of the funds derived from the exploitation of natural resources.

Any circumstance that leads to the determination of a percentage or sum should be accompanied by a technical justification that can be analysed. It is important to share the template of the calculation which led to the definition of these figures.

CIP believes that the crucial aspects are already in the draft, but there is still room for improvement through including and clarifying the aspects presented in this document and in others presented by other bodies.

7 The primary balance is calculated by the difference between State Revenue (before loans and grants) and total expenditure, excluding debt charges. The balance may be in surplus or in deficit, and in the case of the budget data, it is in deficit and this constitutes a primary deficit.

Documents consulted:

• Bank of Mozambique (2020), **Proposta de Modelo do Fundo Soberano para Moçambique**. Available on the site http://www.bancomoc.mz/, consulted on 30/11/2020

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