Policy Brief

DEVELOPING NATIONAL STRATEGY AND THE ROLE OF SOVEREIGN WEALTH FUND TO SUPPORT SUSTAINABLE INFRASTRUCTURE PROJECTS

Task Force 8
Inclusive, Resilient, and Greener Infrastructure Investment and Financing
Juergen Braunstein (Harvard University and Vienna University of Economics and Business)

Marinella Davide (Harvard University and Ca’ Foscari University)

Julius Sen, (London School of Economics and Political Science)
Abstract

The scale of the global infrastructure investment gap over the next two decades raises the question of where and how governments can access the additional finances to deliver the required level of sustainable infrastructure. Mobilising private finance is critical for closing the infrastructure gap particularly in lower-middle income countries.

Sovereign Wealth Funds (SWFs) – large state-owned investment funds – can play a critical role in incentivising and unlocking private national as well as international finance to enable low-carbon infrastructure investment that is aligned with the Sustainable Development Goals (SDGs).

The following actions will enhance the role of SWFs and public policy incentives to mobilising private investment in supporting the national infrastructure strategies. We propose a National Strategy Coordination Mechanism (NSCM), which would not only provide guidance in terms of governance coordination among national entities but also enhance long term certainty beyond ad-hoc projects and one-off investments within and across nations.
Challenges

The scale of the global infrastructure investment gap over the next two decades raises the question of where and how governments can access additional finances to deliver the required level of sustainable infrastructure. Mobilising private finance is critical for closing the infrastructure gap particularly in low- and middle-income countries.

Infrastructure, such as transportation systems, energy generation structures and networks, water and sanitation facilities and telecommunication services, are a crucial component of socioeconomic development and at the base of people and businesses’ activity.

Underinvestment represents a missed opportunity in terms of progressing towards improved welfare and the achievement of sustainable and inclusive development. In the long term, infrastructure investment is estimated to have a socioeconomic rate of return of 20 percent – meaning that every dollar invested can increase GDP by 20 US cents – or even higher in countries with larger infrastructure needs (MGI 2016). The expenditure amount is not the only factor to consider. The quality of investments is also crucial to realising long-term related benefits. Recent studies also suggest that improving the quality of infrastructure can be effective in alleviating the impact of natural disasters (Taghizadeh-Hesary, Yoshino, and Mortha 2019).

By exploring different sets of scenarios, a recent World Bank report finds that new infrastructure could cost low- and middle-income countries between 2 and 8 percent of GDP per year to 2030, depending on the quality and quantity of service targeted and the spending efficiency achieved in reaching this goal (Rozenberg and Fay 2019).

A range of public and private financial sources will be required to deliver infrastructure. In particular, minimum capital investments needed for basic services like electricity, transportation, water and sanitation, irrigation, and flood protection, which account for $640 billion annually. Higher expenditure is required to enable low- and middle-income countries to achieve the infrastructure-related SDGs and stay on a path consistent with the objective to limit temperature warming to 2 degrees Celsius.
Investments in low-carbon energy, efficient mobility infrastructure, advanced water and sanitation technologies are predicted to increase investment requirements to $1.5 trillion a year (4.5 percent of GDP) (Rozenberg and Fay 2019, 6). In all scenarios, major expenditure is for electricity and transportation infrastructure (about half of the total) (Rozenberg and Fay 2019). To be achieved, these objectives need the support of targeted policies and national strategies.

Countries at different levels of development and financial maturity face different financing challenges with regard to their infrastructure. High-income countries have debt and equity financing options. Infrastructure projects such as renewable energy production and distribution, water networks and building improvements can generate consumer revenue streams that are important to incentivise private investors to purchase equity as a long-term investment. In stark contrast, many lower-middle income economies are confronted with private capital shortages. Due to their low-income level, per capita return on user fees are too low to offer sufficient return on investments and risk perception is high. The big challenges for many developing economies are shallow debt markets and lack of credit ratings – which make it difficult to tap into funds from capital markets via issuance of infra bonds or project bonds (Floater et al. 2017).
Proposals for G20

SWFs – large state owned investment funds – can play a critical role in incentivising and unlocking private national as well as international finance to enable low-carbon infrastructure investment that is aligned with the SDGs.

The following actions will enhance the role of SWFs and public policy incentives to mobilise private investment in supporting the national infrastructure strategies.

SWFs can play a critical role in crowding-in international and national private finance to complement national and municipal funding sources. An increasing number of SWFs are being established under conditions of capital scarcity – especially in low- and lower-middle income countries such as India, Indonesia, Egypt and Nigeria – with objectives to contribute to national infrastructure development. Their primary objective is to serve as a credible institutional partner to mobilise new inflows of foreign investment capital. Recently established funds, with development or strategic investment mandates, include those designed to catalyse foreign direct investments into strategic sectors of the host country’s domestic economy.

Many of these new SWFs are dedicated finance institutions seeded by public capital. These types of SWFs can be considered an emerging subset of national or regional development banks – government-backed lending institutions for which there is a long track-record. In emerging markets, they can be particularly useful for drawing in bilateral or multilateral development finance or climate finance to meet local, transactional needs, where domestic public or private funds are likely to be more limited than in mature economies.

A new trend: Sovereign wealth funds with infrastructure mandates

Trends in new fund creation, especially in lower-middle income countries represent a fundamental shift in the SWF landscape. SWFs have traditionally been created to recycle excess reserves from oil/gas revenues in order to mitigate related negative externalities, such as volatile fiscal revenues, Dutch disease or capital supply shocks (Schena, Braunstein, and Ali 2018).
So called “stabilisation funds” or “rainy day funds” smoothen budget revenues and/or currency fluctuations, and hedge against capital supply shocks in an international environment of high capital mobility. They absorb excessive liquidity (i.e. money supply) in periods of high external income. Without the absorption of excessive liquidity through an SWF (e.g. in commodity-exporting countries during boom times), capital inflows can cause the appreciation of the domestic currency and thus undermine the international competitiveness of the domestic industry.

Countries with more surpluses/reserves than are needed for stabilisation purposes frequently create additional funds with savings mandates. For example, the Kuwait Investment Authority and the Abu Dhabi Investment Authority (ADIA) refer to SWFs with a mandate of sharing wealth across generations. Like commodity exporters, countries with persistent trade surpluses – especially in Asia – accelerate the accumulation of foreign reserves and invest in a broad range of assets classes across global markets. Reserve investment corporations such as the Korea Investment Corporation and Singapore’s Government of Singapore Investment Corporation (GIC), aim to earn higher returns on excess reserves (Braunstein 2022). Although each of these SWFs may have different specialist objectives (e.g. saving for future generations, meeting contingent pension liabilities not covered by pension schemes or preservation of the long-term purchasing power of reserves), they share the common goal of ensuring that a country’s savings are optimally deployed over the long term.

SWFs in lower-middle income countries countries are usually smaller, in absolute and relative terms, than their peers in middle- and high-income countries. However at the same time lower-middle income countries have relatively higher levels of capital demand for infrastructure investments. India’s ambitious infrastructure agenda, the National Infrastructure Pipeline, announced in 2019 comprises $1.5 trillion until 2025 to be invested across a wide range of sectors. Indonesia also plans to spend $430 billion by 2024 on infrastructure (Kim 2020). As such, India’s and Indonesia’s infrastructure SWFs with volumes of $4.3 billion and $5 billion respectively are well beyond what is needed to finance their national infrastructure programmes (NIIF 2022; INA 2022). In turn, that requires the raising of additional capital from private and international investors.
Catalysts for blended finance

Governments’ ability, then, to create and facilitate deployment of blended finance, i.e. using targeted public funds to leverage and “crowd-in” private finance to specific investment projects or finance facilities, is critical. Blended finance is more than just a mechanism for complementing government funds with those from commercial/institutional sources. It can also activate and draw from technical and implementation skills of civil society actors, philanthropic institutions, development banks and private for-profit institutions (UN General Assembly 2014).

SWFs can play an important role in enhancing investment flows but there needs to be a clear articulation of their strategy and its alignment with government policy. Yet very few governments, developed and developing, have well-articulated strategies and investment plans for sustainable infrastructure. Sustainable infrastructure and urbanisation need to be placed at the centre of long-term national plans for financial reform and industrial strategy. This has already started tentatively in some countries. However, national plans and industrial strategies are needed urgently in countries at all levels of development that provide the market incentives for a transformation in urban infrastructure financing. National governments also play a strong enabling role in setting market conditions that draw in private sector capital to sustainable infrastructure programmes. Direct government investment can provide a foundation that demonstrates long-term commitment, builds skills and provides performance evidence needed to steer towards green growth. But facilitating entry of the far-greater private capital sources requires a mix of non-financial actions beyond direct investment, i.e. enacting supportive policies, standards and regulations, pricing signals and improving information flows.

In order for SWFs to play the role as catalysts for blended finance, it requires the clear articulation of a SWF strategy that is aligned with the long-term national strategy. That is critical to answer the question of how the SWF, as an agent of the state in contexts of capital scarcity, can serve as a credible institutional partner to mobilise new inflows of foreign investment capital.

That involves the formulation of effective responses to key investment barriers. Key barriers can relate to political and currency risks, the investment horizon, lack of information and the risk of low return. To formulate a strategy that is aligned with the long-term national strategy requires first to answer a number of questions:

---

DEVELOPING NATIONAL STRATEGY AND THE ROLE OF
SOVEREIGN WEALTH FUND TO SUPPORT SUSTAINABLE
INFRASTRUCTURE PROJECTS
1. What is the additionality of a SWF with an infrastructure mandate in the respective context?

- SWFs can play a critical role in addressing imperfect information, which is a barrier for many international investors that are unfamiliar with emerging markets and local conditions.

- Strategy of how to interact with which actors and their risk return profiles. Blending allows for multiple financiers to pool capital for projects that are too large or too risky for a single entity to underwrite on its own. It is a way to layer multiple capital types and sources with differing risk appetites, rate of return expectations and investment horizons. Blended finance is optimally applied to projects and finance structures marginally below real or perceived commercial viability, and that cannot be unlocked by an enabling policy and institutional environment alone (UN General Assembly 2014).

- SWFs can play an important first step in mitigating some of the barriers to international capital and private investors. SWFs also could bundle numerous small projects mismatched with large capex strategy. Blended finance is more than just a mechanism for complementing government funds with those from commercial/institutional sources. It can also activate and draw in the technical and implementation skills of civil society actors, philanthropic institutions, development banks and private for-profit institutions (Floater et al., n.d.)

- The building of in-house investment capacity. Closely linked to the previous point, the building of in-house investment capacity refers to an activity whereby the SWFs extend their exposure in the direct and day-to-day management of their portfolios across different asset classes. Capacity building requires a strategy of identifying partners across the value chain of project investments. Coinvesting allows investors to tap into specialist expertise and to get important exposure to market transaction to which it is not yet prepared to do on its ow. India’s National Infrastructure Investment Fund coinvests and partners with ADIA, the Asian Infrastructure Investment Bank (AIIB), the Asian Development Bank (ADB), the New Development Bank, Temasek and the Ontario Teacher Pension Plan.
### Table: Financial Sources and Examples

<table>
<thead>
<tr>
<th>Financial sources</th>
<th>Examples</th>
<th>Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Risk profile</td>
</tr>
<tr>
<td>National public finance</td>
<td>National government</td>
<td>Medium-high</td>
</tr>
<tr>
<td></td>
<td>National development banks</td>
<td>Medium-high</td>
</tr>
<tr>
<td>International public finance</td>
<td>Multilateral development banks</td>
<td>Medium</td>
</tr>
<tr>
<td>Intermediaries</td>
<td>Commercial banks and investment companies</td>
<td>Medium-high</td>
</tr>
<tr>
<td></td>
<td>Developers and infrastructure operators</td>
<td>Medium-high</td>
</tr>
<tr>
<td></td>
<td>Private equity and infrastructure funds</td>
<td>Medium-high</td>
</tr>
<tr>
<td></td>
<td>Pension funds and insurance</td>
<td>Low</td>
</tr>
</tbody>
</table>

### 2. Does an SWF complement or compete with private capital?

The legal status and privileges under which an SWF with an infrastructure mandate operates are important factors affecting the degree of competition between the state and private enterprises (e.g. in terms of tax exemptions, government guarantees, transparency, capital access and bidding for government tenders). For example, the Indonesia Investment Authority (IIA) emphasises the full support from the president special tax treatment and the ability to navigate and accelerate regulation and permit issuance (INA 2022).

Temasek was created under the Companies Act as a private exempt company, which is any private company that is wholly owned by the Singapore government (Singapore Companies Act, Chapter 50/4). This status has allowed more flexibility, because Temasek was not subject to the same limitations as other private companies, as provided in law (Braunstein 2022). Although Temasek’s companies between the 1970s and 1980s were primarily involved in strategic capital-intensive sectors in which private capital was hesitant to invest, it also actively competed with domestic entrepreneurs...
in non-strategic sectors, such as in the food, manufacturing and retail sectors. A number of government-linked companies – controlled by Temasek – emerged in sectors that were in direct competition with domestic private entrepreneurs. These included logistics, manufacturing, food processing, hospitality, printing, heavy industry, real estate, insurance and finance (Braunstein 2017).

3. **To what extent does a particular fund design evolve as an endogenous strategy?**

Successful SWFs have frequently emerged in particular strategic contexts, which makes a “copy paste” of seemingly successful SWFs to other countries problematic. In 2016, Turkey announced its intent to create the Turkish Wealth Fund along the model of Singapore’s SWFs. Like Temasek, the Turkish Fund has also been capitalised by the transfer of state holdings. In February 2017, the government announced the transfer of its stakes in a number of high profile companies, such as Turkish Airlines, the Turkish oil company, Halkbank and Turk Telekom, into the SWF. The size of the fund is estimated by Turkish authorities to potentially reach $200 billion (Kandemir and Ersoy 2017). As a result of the asset transfers, annual dividends of state-owned enterprises (SoEs) will be diverted from the central budget to the SWF (Schena, Braunstein, and Ali 2018). Such an asset transfers will also divert dividends from Turkey’s central budget raising the spectre that the SWF capital might be used to finance government budget deficits. To reiterate, modes or strategies of fund capitalisation have tangible consequences for the sustainability of public finance and warrant a careful analysis of fiscal impacts. Importantly, these also include residual or indirect impacts on sovereign credit quality.

4. **Do SWFs help crowd-in other capital which would not have otherwise come in?**

The Senegalese strategic investments fund (FONSIS), for example, has partnered with the French infrastructure fund Meridiam Capital to finance solar utility in Senegal. Morocco similarly established Ithmar Capital as a strategic investment fund in 2011 with the purpose of mobilising national and international investment into the tourist sector. Financed by the government, Ithmar Capital coinvests in Moroccan projects with other SWFs. For example, its joint venture – Wessal Capital – with several Gulf funds financed the redevelopment of the port of Casablanca. Playing leader role in addressing asset performance in new technology.
Recommendation: National Strategy Coordination Mechanism

While the SWFs with infrastructure mandates share many features, they remain very diverse in terms of their size, liability-structures and funding sources. An SWF with “non-traditional” sources of funding – special taxes, immigrant investment flows, collateralised debt proceeds, privatisation or SoE restructuration management – introduce a variety of new actors with implications for SWF governance and coordination. Actors involved in the policy dialog will inevitably expand from finance ministries and central banks to other government departments, such as those engaged in innovation, immigration, SoE management and economic development. As more subsidiary players get involved in the domestic decision making environment regarding SWFs, the need for developing a clear national strategic framework – linking SWF investment policies to a country’s long-term strategic goals – becomes more important.

Group of 20 members can begin by understanding the specific issues related to their own countries. Interdependence within and among these areas requires a new approach to governance that is attuned to targeting global issues such as climate change and domestic infrastructure needs that are unique in how these features combine to create governing structures and challenges, making for different approaches.

What is missing is a high level National Strategy Coordination Mechanism (NSCM). It would look like this: mixing the fund’s objectives with the strategic long-term goals of the economy and catalysing inward investment. Such a framework not only provides guidance in terms of governance coordination among national entities but also enhancing long term certainty beyond ad-hoc projects and one-off investments within and across nations through collaboration. Coordination mechanisms among different frameworks would be needed in order to facilitate replication and scale-up green project pipelines. Investors will join if they have greater certainty that follow-on projects will be available, achieve scale and establish a pipeline of investment-grade projects and promote levels of inhouse investment capacity development.

A focus on national strategies would add significant value to existing policy and technical fora (e.g. the OECD Long-term Investment Project, One Planet Sovereign Wealth Funds Framework, the G20 Guiding Principles for Global Investment Policymaking and the Santiago Principles) to enhance collaboration and smoothen interaction in sustainable and infrastructure investments among countries. The G20 is an ideal forum for initiating dialogue about the coordination of national infrastructure projects in the context of...
different national strategic frameworks. This dialogue can take place under the auspices of existing G20 initiatives, such as the Global Infrastructure Hub.

Acknowledgments:
Juergen Braunstein kindly acknowledges funding from the Austrian Science Fund (FWF): J 4302-G31. Marinella Davide kindly acknowledges funding from the European Union’s Horizon 2020 research and innovation programme under the Marie Sklodowska-Curie grant agreement No 841291.
References


