

Oil Prices & the Impact on Sovereign Wealth Funds

By Omar Khattaly · 8 January 2016

The drop in oil prices over the last 12 months has taken markets and investors by surprise. State institutions such as Sovereign Wealth Funds (SWFs) have been affected, and government budgets have come under pressure. SWFs are expected to grow at a slower pace, and in many cases may see some of their assets decline in value or be liquidated to help cover government budget deficits. State foreign exchange reserves are also likely to be impacted.

There are over 77 SWFs in existence, with total assets exceeding $7.1 trillion, of which approximately $4 trillion are oil- and gas-related funds. By the end of 2015, more than 56% of SWF assets originated from the sale of oil and gas products. These funds account for approximately 5–10% of total capital invested in global markets.

In the past six months, investment managers have observed an increase in capital outflows back to these funds, totaling over $19 billion in the last quarter of 2015, according to eVestment, the data provider. As oil prices have continued to

decline—from a high of $120 per barrel a decade ago to below $30 in early January 2016—many governments in the Gulf region, Africa, and Asia are becoming increasingly concerned about managing their budgets and meeting domestic financial obligations. Libya and its sovereign wealth fund will not be an exception.

Let us look at some numbers and data to give the reader a clearer idea of how severe the situation is.

The Saudi Arabian Monetary Agency (SAMA), the kingdom's investment arm, has liquidated and withdrawn over $70 billion from external managers in the last six months to support domestic spending and the economy. Some analysts estimate that the actual figure may be well over $100 billion. According to NASDAQ, SAMA has withdrawn over $1.3 billion from European equities.

According to official releases and statements by the Central Bank of Kazakhstan, the government is expected to withdraw $28.8 billion from its sovereign wealth fund over the next three years to cover oil-related revenue losses. The country's president, Nursultan Nazarbayev, warned last year that government budget revenues had fallen by 40% due to lower oil prices. Kazakhstan's $64.2 billion SWF has already declined by nearly 18% in value and is expected to be depleted within 10 years or less if oil prices remain at current levels.

The Qatar Investment Authority (QIA) announced in October 2015 that it was selling its 10% stake in the German construction company Hochtief, valued at $615 million. QIA also sold stakes in the French construction conglomerate Vinci, as well as two office buildings in London. In addition, QIA has been in talks to sell the film studio Miramax.

Qatar's finance minister has reportedly stated that the government will need to borrow $12.8 billion to cover the 2016 budget deficit. As a result, many government projects have been put on hold, and layoffs have been implemented.

Norway, home to the world's largest sovereign wealth fund, has lost over $120 billion in value, declining from a high of $900 billion at the end of 2014 to approximately $780 billion currently. According to Egil Matsen, deputy central bank governor responsible for overseeing the fund, Norway will not sell off assets to cover government revenue losses or the 2016 budget deficit. Matsen expressed confidence that the government can manage without accessing the fund, which is intended for long-term use.

Kuwait has recorded a budget deficit of $3.6 billion in the first five months of its current fiscal year. To address this shortfall, the government has implemented

measures such as increasing corporate taxes on profits, raising service fees, and reducing subsidies. Despite running a deficit in 2016, Kuwait continues to contribute to its sovereign wealth fund, allocating 10% of oil revenues instead of the legislated 25%.

Algeria is expected to face a $23 billion deficit in its 2016 budget, with oil accounting for over 60% of government revenue. Many analysts predict that the government may need to draw from its $50 billion Revenue Regulation Fund to meet financial obligations. Over the past 12 months, Algeria has already relied on its foreign exchange reserves, which declined from $178 billion at the end of 2014 to approximately $150 billion by the end of 2015—representing a drop of more than 12%. The government is also considering increasing taxes, import duties, and the prices of subsidized fuel and electricity.

There are numerous other global examples illustrating the impact of falling oil prices. Chile's state-owned stabilization fund declined from $15.5 billion in 2014 to $14 billion. Similarly, Azerbaijan's foreign exchange reserves fell sharply from $16.5 billion in 2014 to $7.3 billion, while Nigeria's reserves dropped from $48 billion in 2013 to approximately $28.7 billion today.

These examples clearly demonstrate how the global oil glut has affected the economies of oil-producing countries. Libya will not be immune to this impact. In fact, Libya is likely to suffer one of the most severe consequences for the following reasons:

- Since 2011, Libya's small economy has largely come to a halt. Oil production has dropped from a high of 1.6 million barrels per day (bpd) in 2010 to approximately 362,000 bpd currently, with some export terminals either damaged or under militia control.
- Libya's current political situation—characterized by two competing governments, a divided nation, a decline in the value of its currency against the U.S. dollar and the euro, high unemployment, a large public-sector workforce, a costly subsidized food and fuel system, and limited alternative revenue sources—makes it extremely difficult for the central bank and government to balance the budget.
- Over the past four years, the Libyan government has drawn heavily on its foreign exchange reserves at an unprecedented rate to cover its large public-sector payroll, which accounts for nearly 30% of the population.
- At present, Libya's economy is in disarray, and inflation is rising.
- Even if the political situation is resolved, the economy is likely to continue

struggling. With oil prices below $30 per barrel and production costs around $23, the government may have no choice but to rely further on foreign reserves and liquidate some assets from its sovereign wealth fund, the Libyan Investment Authority (LIA), in order to meet its financial obligations.

- Development programs will likely need to be put on hold, and the government will be forced to implement serious and decisive measures to reduce spending and develop a strategy to recover from the crisis.

Here is a sample of experts' opinions on how dropping oil prices will affect SWFs:

- **Alberto Gallo** , head of macro credit research at Royal Bank of Scotland Plc, notes: "If the current drop in oil prices persists, it will affect the value of many SWFs and their ability to pour money into the investment world." He adds that "Petrodollars are becoming Petropennies." According to the bank, the gross flow of petrodollars into the global economy fell to as little as $200 billion last year, down from nearly $800 billion in 2012.
- According to a blog post by IMFDirect: "Governments will likely be transferring less revenue than before to these SWFs. At the same time, pressures to draw down on sovereign wealth fund assets will probably rise."
- **Elena Duggar** , a senior vice president at Moody's, states: "As a result, we expect increasing use of sovereign wealth fund assets to finance budget deficits and support domestic economies."
- **Jeffrey Levi** , a partner at Casey Quirk & Associates, an investment management consultancy, adds: "There is big pressure on governments because of the oil price drop and they are looking to sovereign funds for cash flow."
- The outflows are expected to continue. Robert Callagy, a senior credit officer at Moody's rating agency, states: "Resource-reliant sovereigns will come under increasing pressure to use SWF assets to plug budget deficits and support domestic economies. This should result in further pullbacks by SWFs from external asset managers."

Implications for the Libyan Investment Authority

The deterioration of Libya's economic climate will profoundly disrupt the Libyan Investment Authority. It is critical that the nation's governing bodies address this revenue shortfall directly through a strategic action plan. This plan must carefully evaluate the country's debt obligations and currency reserves alongside its $67 billion SWF, which has faced severe mismanagement under the weight of the

country's volatile political climate.

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