

Managing Petroleum Wealth and the Government Pension Fund Global

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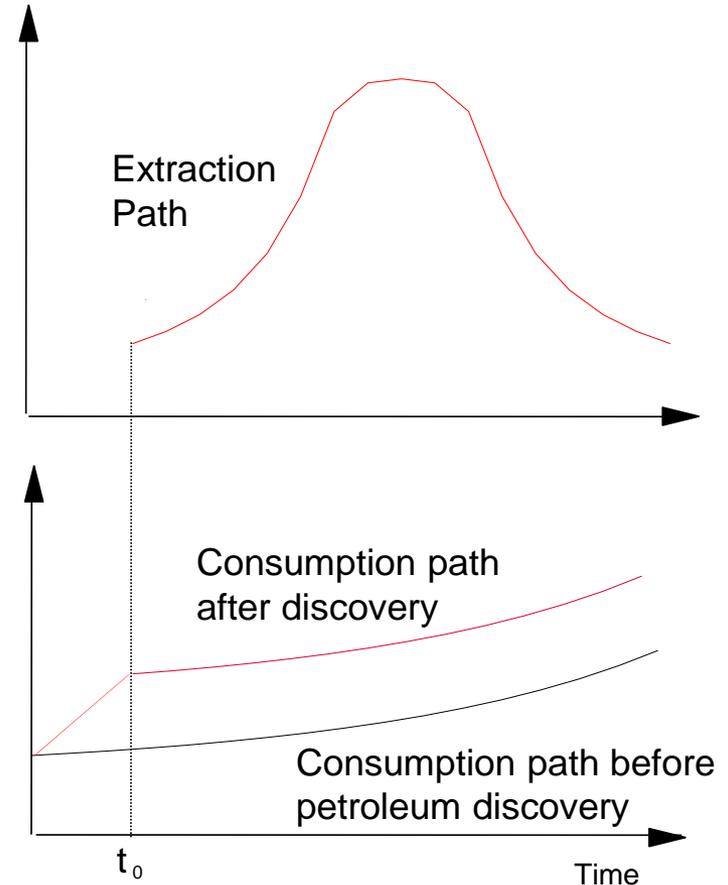


Wealth management

Petroleum revenues differ from regular government revenues:

- Income stemming from depletion of wealth
- More volatile and uncertain
- Governance challenge: “Free money”

- ***Necessary to separate spending from current petroleum revenues***
- ***Need to save large part of current revenues***
- ***Need suitable governance framework***

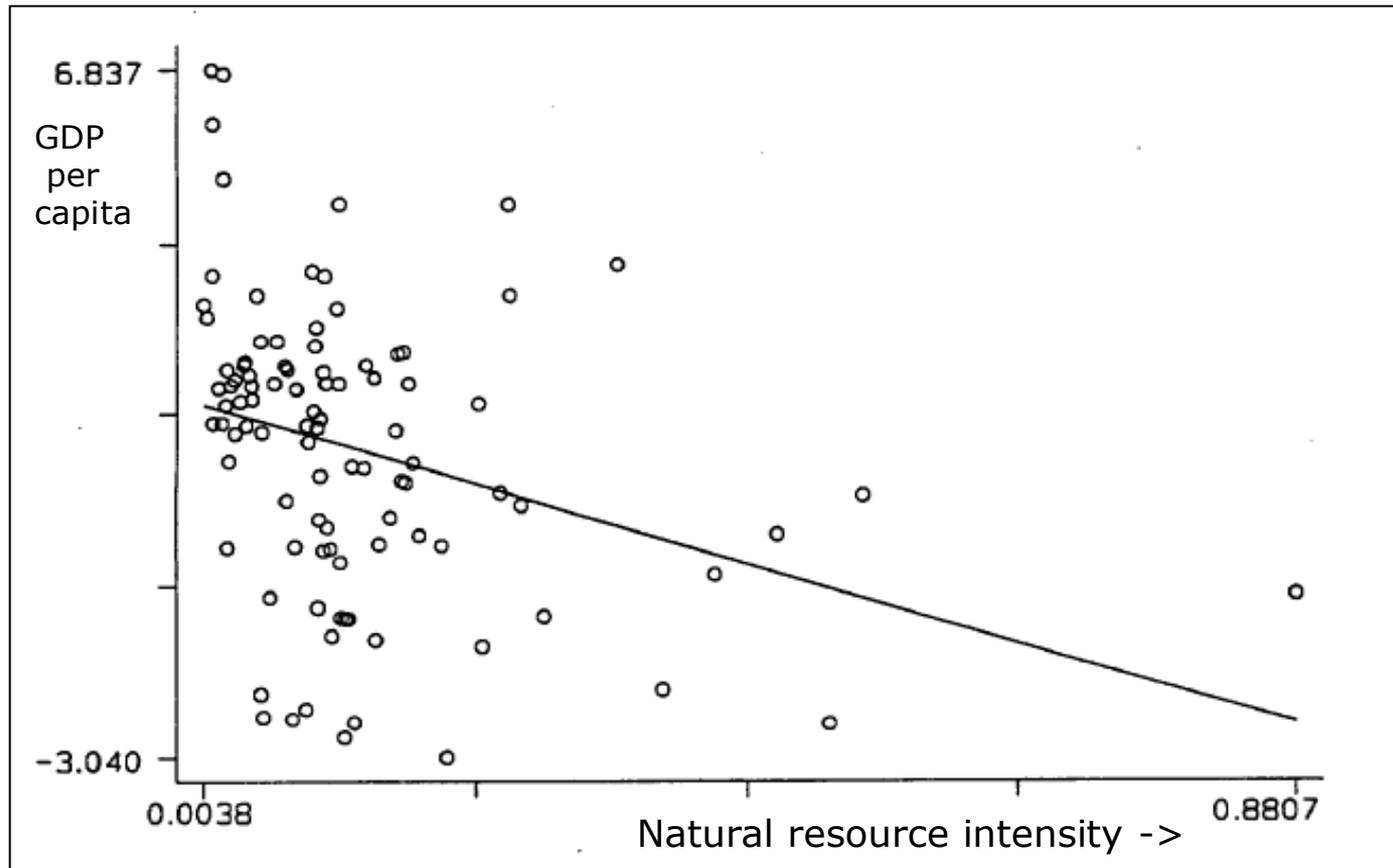


Common pitfalls

1. Lack of fiscal discipline
 - Challenge: How to transform a windfall to a permanent income?
 - Overheating instead of sustained higher growth
 - Dutch disease
2. Bad investments
 - Large scale industry investments with high political prestige
 - Public infrastructure projects with vague/low economic return
3. Loss of focus in structural policy
 - Main focus on how to grab a part of the oil revenues
 - Productivity growth in non-oil activity suffers
 - Labour supply falls
4. Poor governance
 - Resource wealth often associated with weak government institutions
 - Rent-seeking activities
 - Increased risk of corruption

Natural resource income and GDP growth

GDP/capita 1970-89 vs. share of natural resource export in GDP in 1971 for 97 developing countries

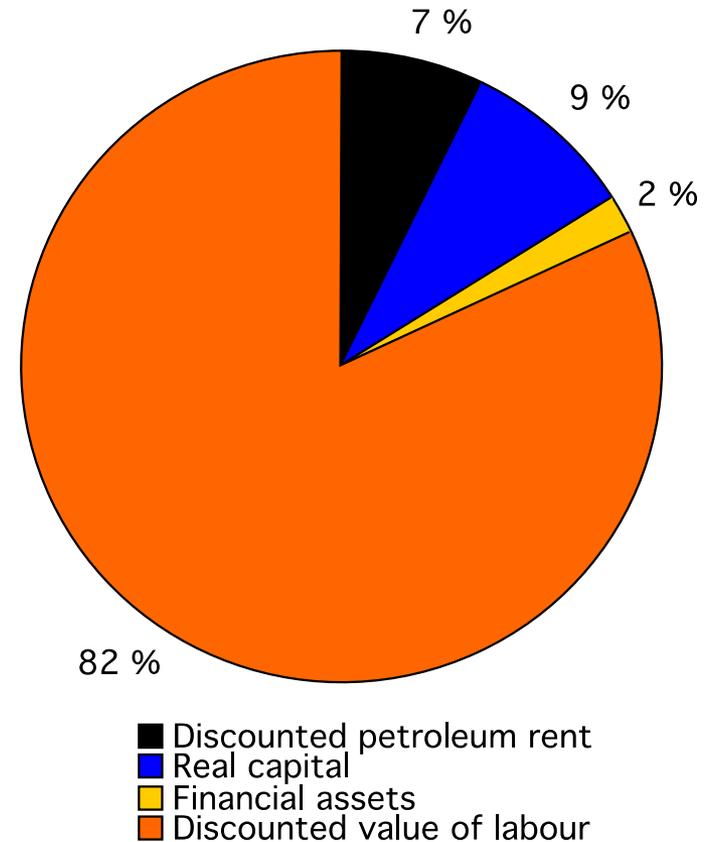


Source: Sachs and Warner (1995)

Manpower is most important resource

National wealth per capita in Norway, 2007

- Pension and tax reform must strengthen work incentives
- Welfare scheme reforms: More people at work - fewer on benefits
- Good policy fundamentals - sustainable macroeconomic policy



Source: Ministry of Finance, NB09

Revenue management – key principles

- An appropriate system for resource management
- An appropriate system for “government take”
- A long-term fiscal policy strategy (integrating oil revenues)
- A good budget process (integrating oil revenues)
- Public sector institutions of high quality
- An informed public. Public ownership of the long-term strategy of managing the petroleum wealth
- Transparency and accountability

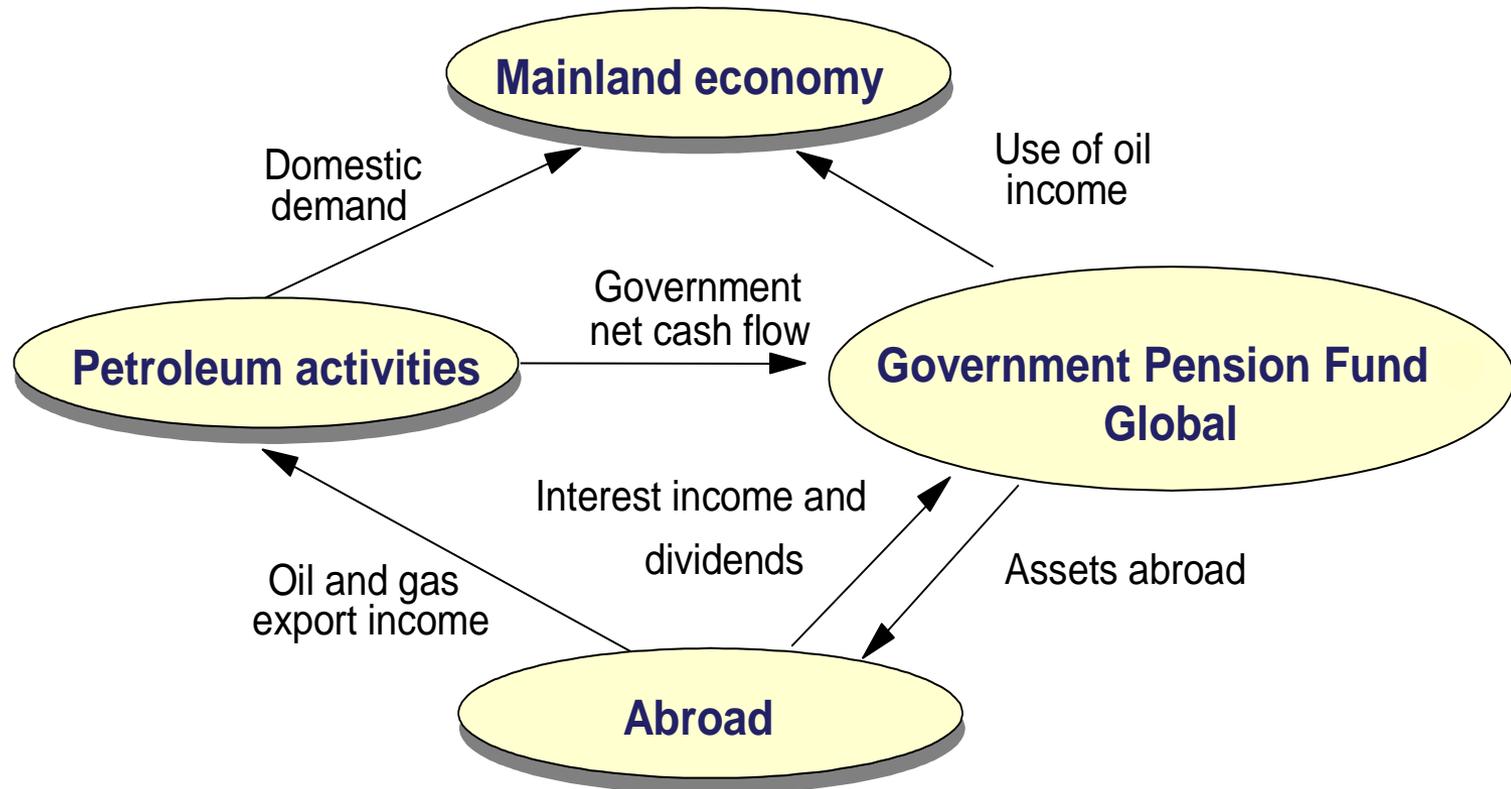
Key idea

- A petroleum fund is no substitute for sound fiscal management. Main priorities:
 - a good budget process integrating oil revenues
 - a sustainable fiscal policy strategy
 - institutions that are competent, transparent and accountable

- A well-designed fund can help build public awareness and support for a policy of wise and long-term management of the petroleum wealth
 - distinguish between savings instrument and savings policy

- A poorly designed fund can do more harm than good.

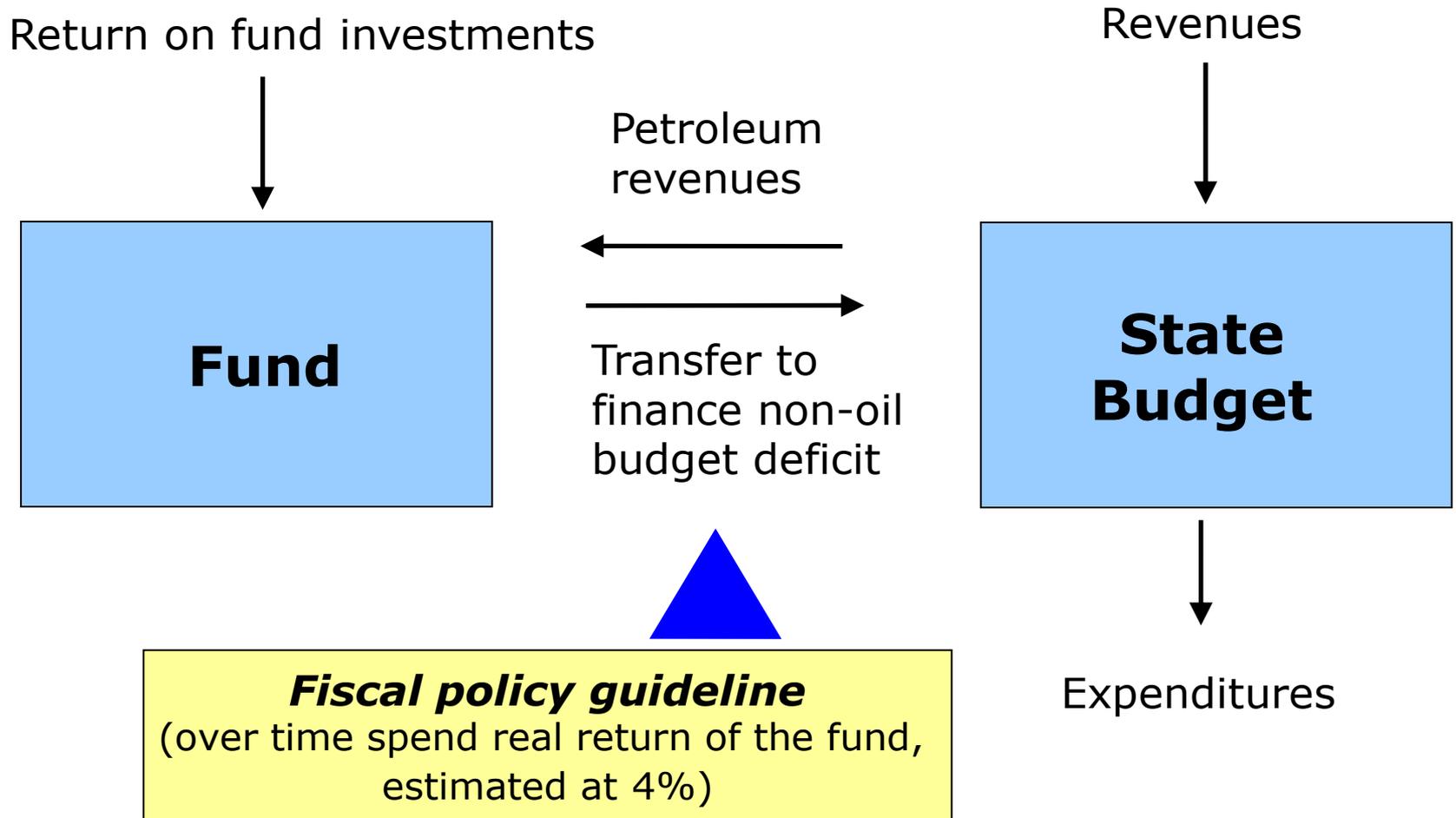
Interaction between the petroleum sector, the Fund and the mainland economy



Different types of funds

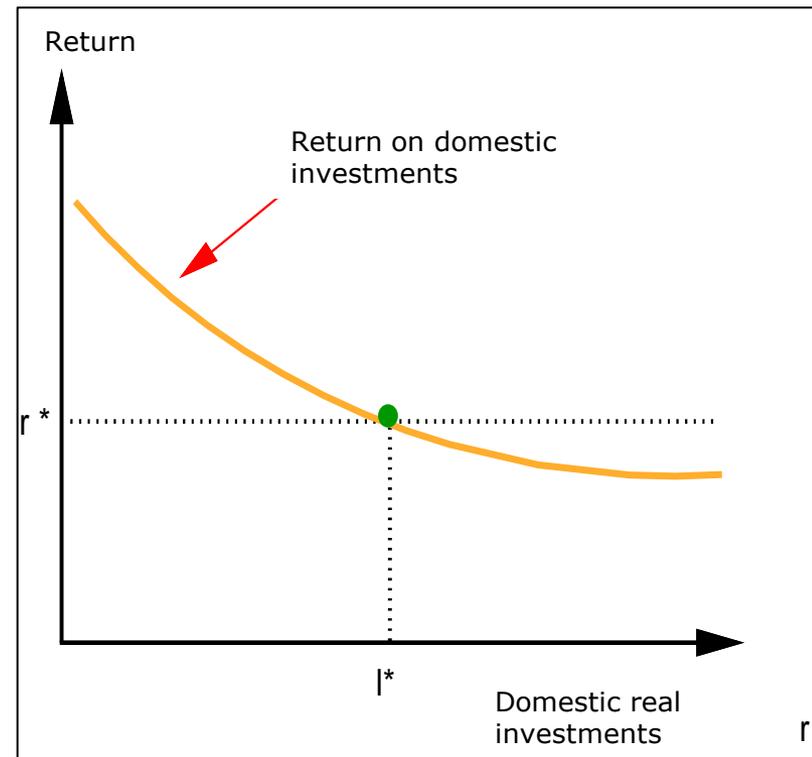
- Savings fund:
 - aim to build up wealth for future generations
 - fixed inflows/discretionary outflows
- Stabilization fund:
 - aim to reduce impact of volatile revenues
 - inflows/outflows contingent on whether revenues are “high/low”
- Financing fund:
 - aim for both saving and stabilization role
 - integrated with state budget. Net inflow equals overall fiscal balance

The Fund mechanism – integrated with fiscal policy



The Global fund does not invest in Norwegian assets

- To expand domestic real investment carries the risk of reducing the return on investment
- Not a lack of capital for private projects in Norway, and the fund should not be a second budget for "less qualified" projects
- An efficient way of achieving capital outflow reflecting the current account surplus
- Shelter the domestic economy from overheating and deindustrialisation



Pension Fund Global Governance Structure

Stortinget



Min. of Finance



Norges Bank

Parliament – “Ultimate owner”

- Political debate on/approval of main policy choices in management of Fund

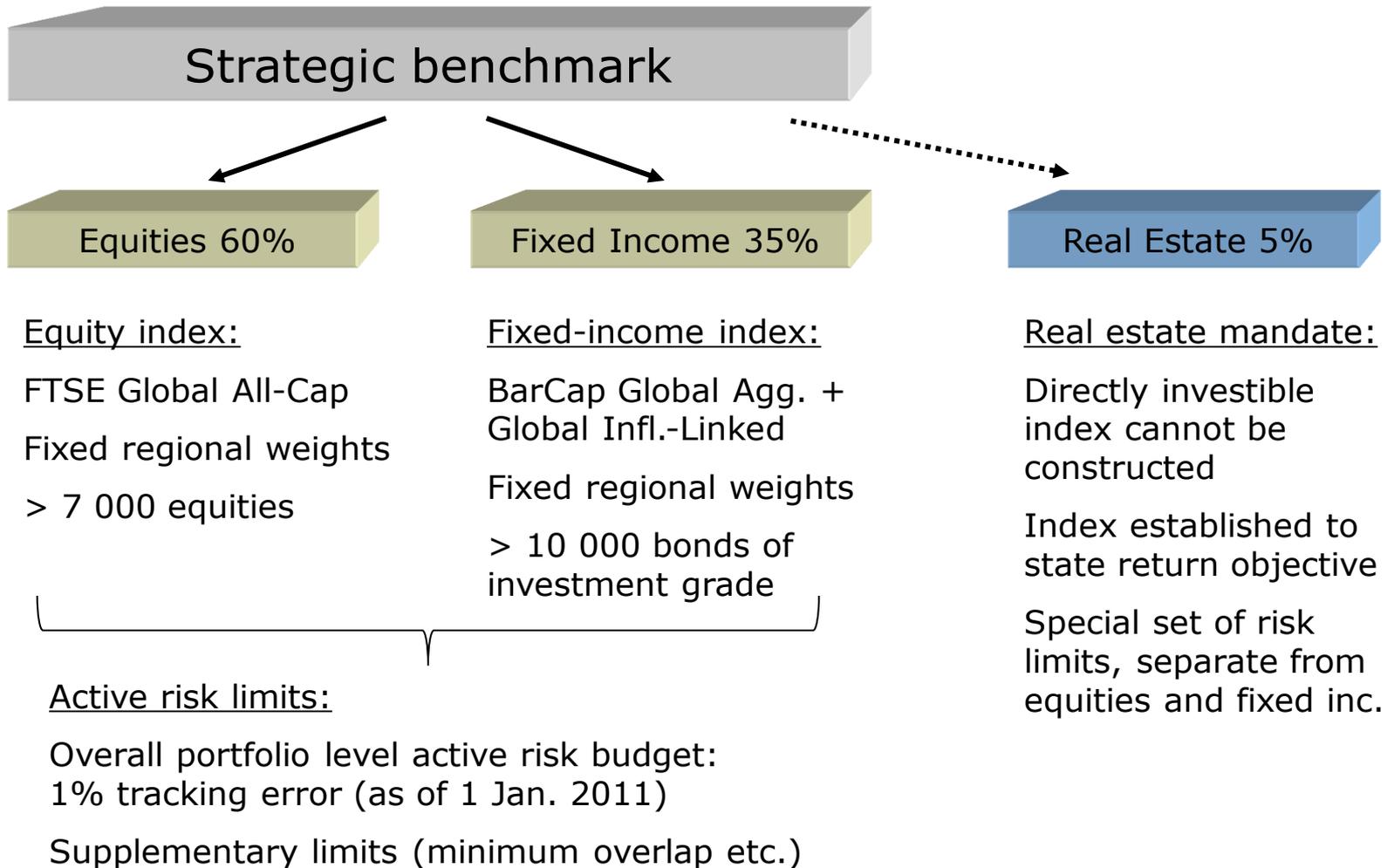
Ministry of Finance – “Formal owner”

- Set benchmark asset allocation + risk limits
- Monitor and evaluate operational mgmt.
- Define responsible investment practices

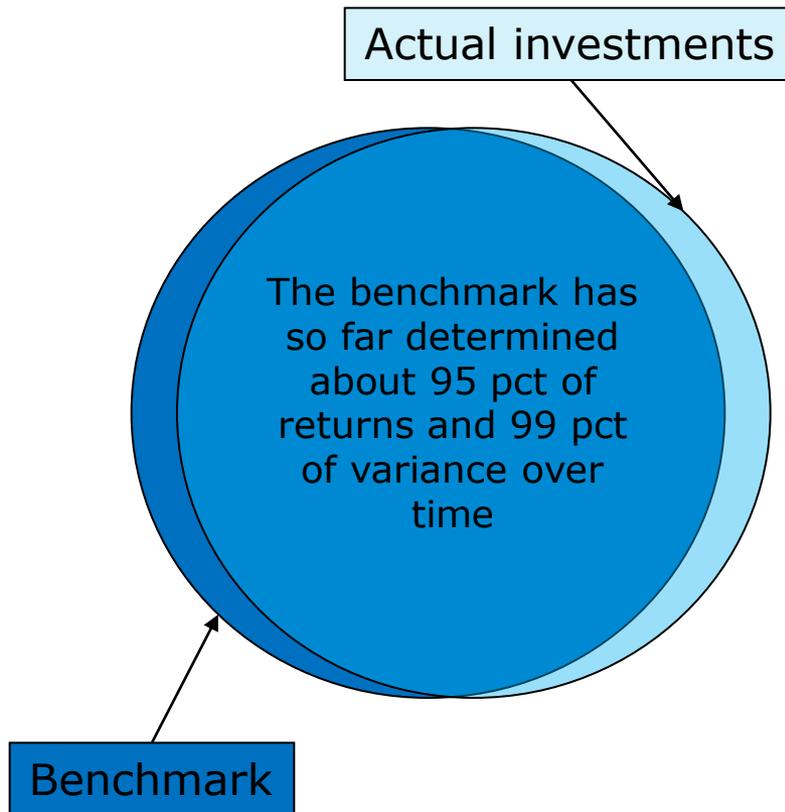
Central Bank – “Operational manager”

- Separate asset management entity (NBIM)
- Implement benchmark asset allocation
- Actively manage portfolio within risk limits to achieve excess return
- Control and report risk
- Exercise the Fund’s ownership rights

Benchmark for the Pension Fund Global



The Fund's total variance is dominated by the market risk of the benchmark portfolio



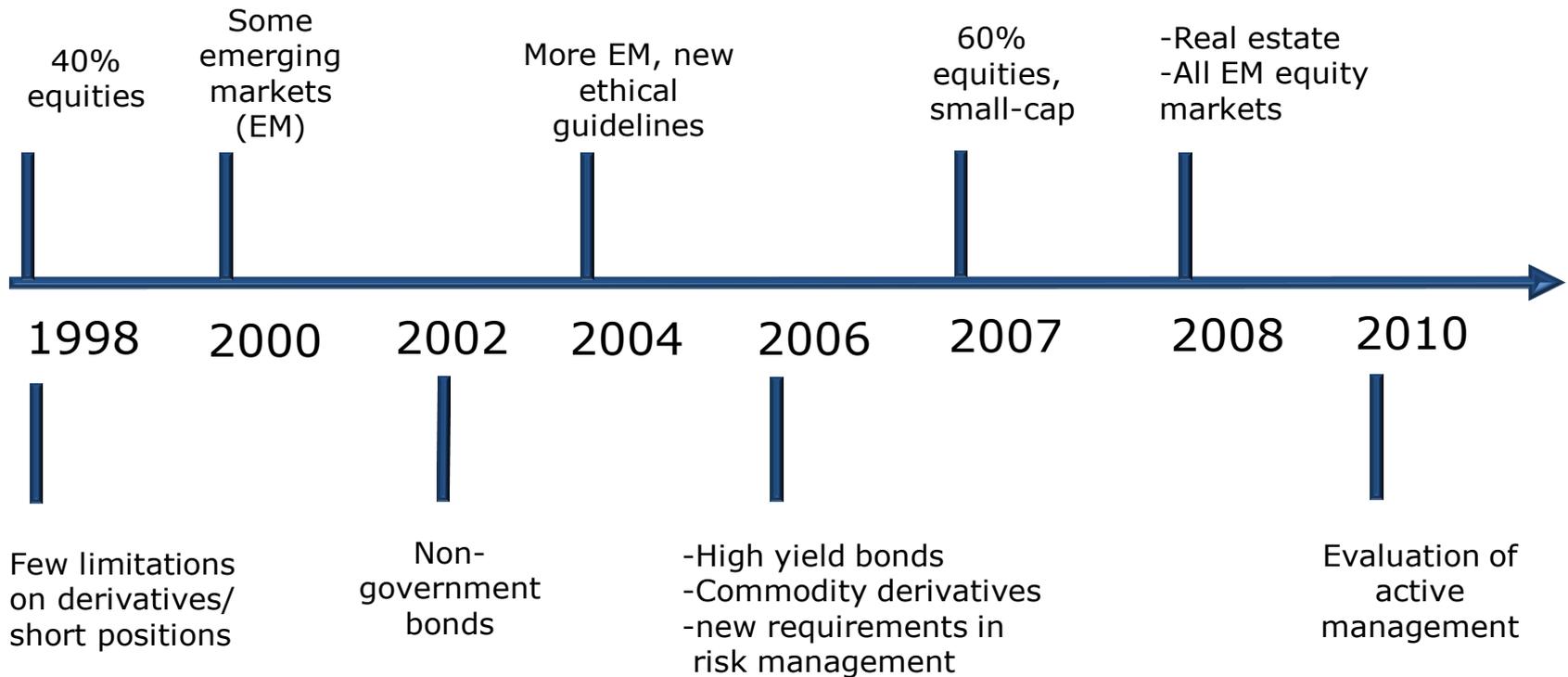
The benchmark

- reflects the owner's chosen investment strategy
- is used for risk management
- is used for assessing manager's skill

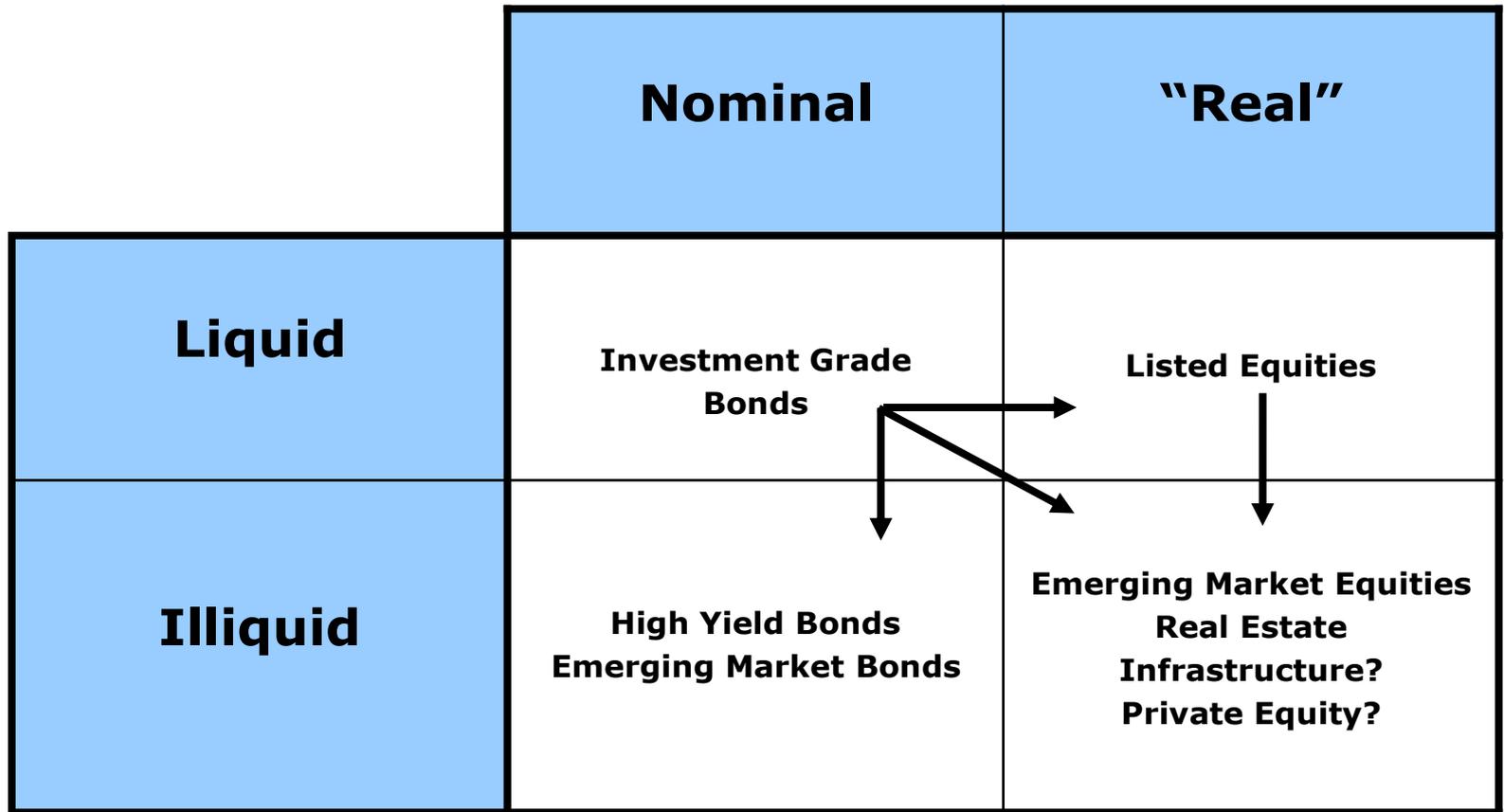
Active management

- The manager can deviate from benchmark
- Quantitative risk limit (1% tracking error), and qualitative requirements

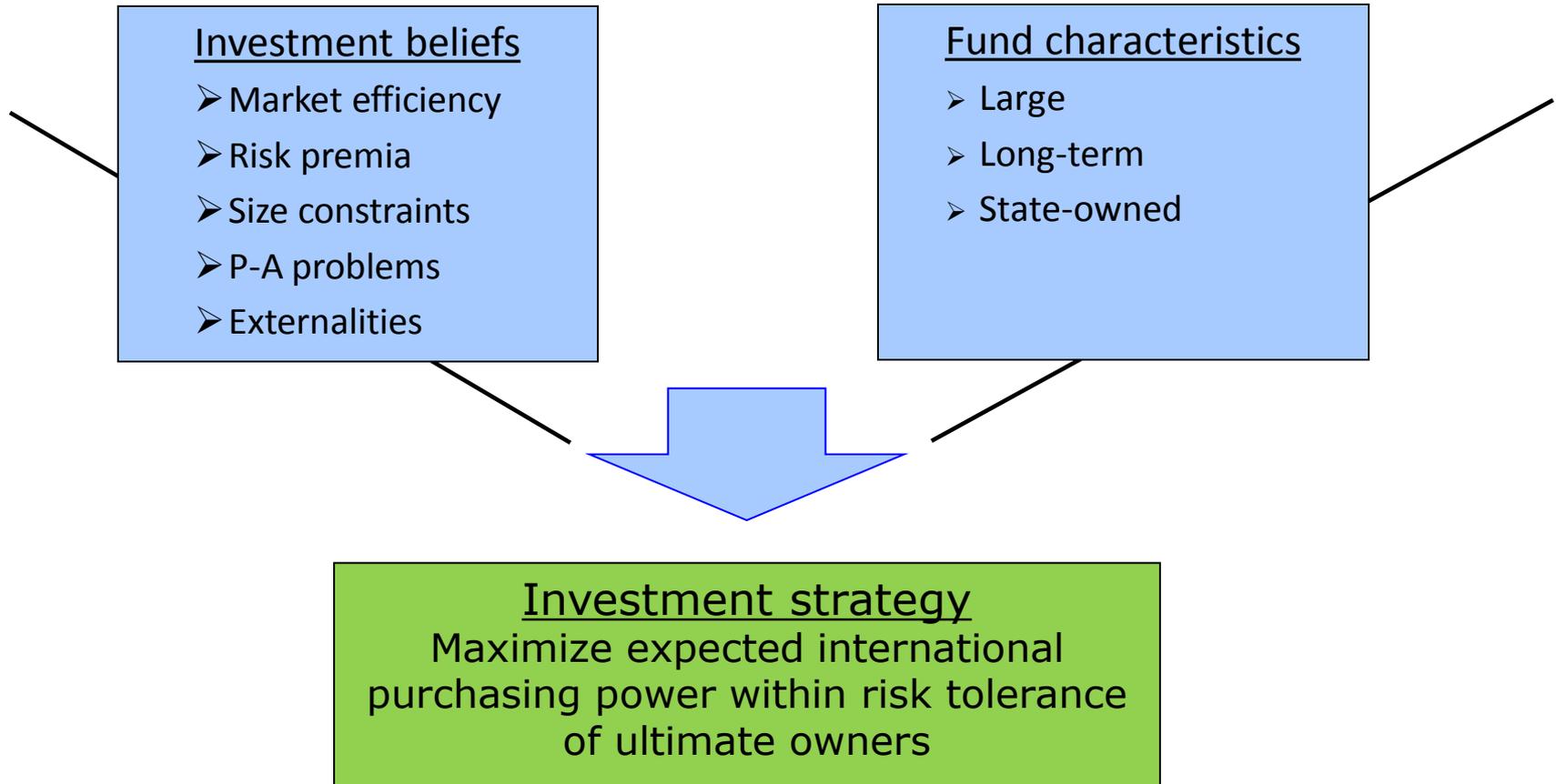
Major changes in the investment strategy



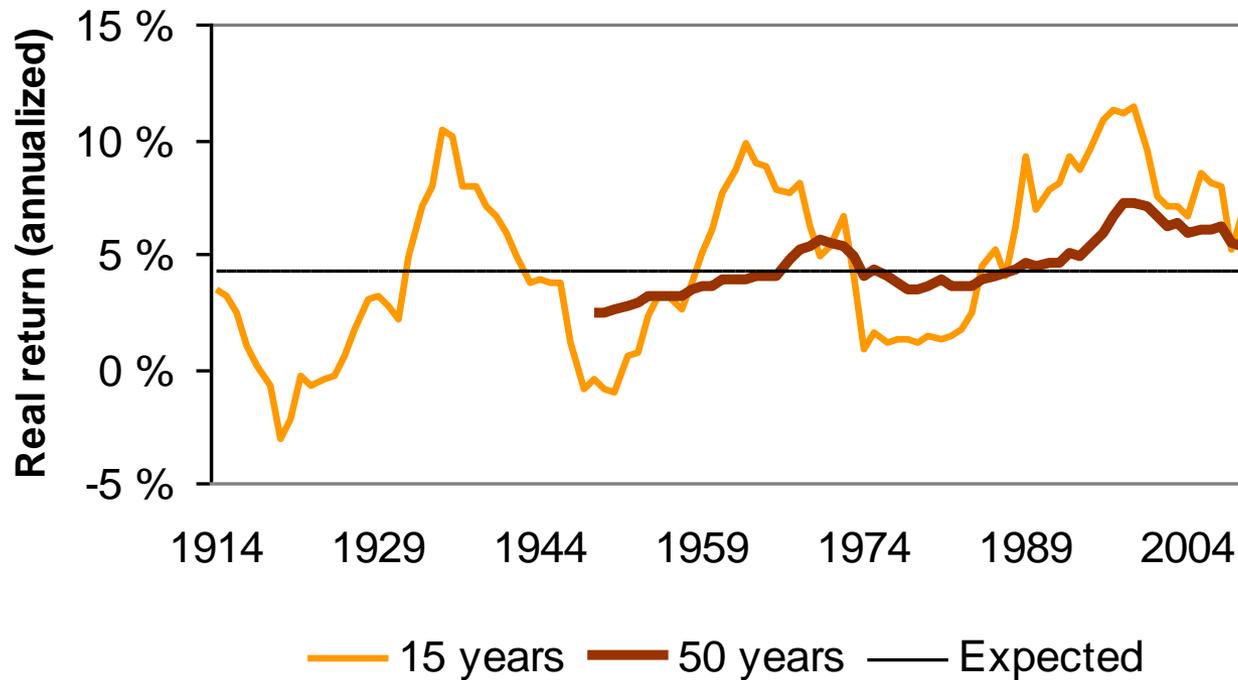
Investment strategy trend: From liquid nominal assets towards illiquid “real” assets



Investment strategy derives from investment beliefs and Fund characteristics



How much volatility are you prepared to live with?



Reporting and transparency

- Ministry reports to Parliament on all important matters relating to the Fund
- Ministry publishes all advice from external consultants
- Performance, risk and costs are reported every quarter and published on website. Focus on contribution to value added in operational management
- Press conference on a quarterly basis, shortly after an official meeting with the Ministry of Finance
- Annual report listing all investments, both equities and fixed income

Some lessons on policy framework:

- Focus on the non-oil economy
 - “Protect” it from petroleum revenues
- Establish a robust and long-term fiscal framework that integrates oil revenues
 - Separate income and spending of oil revenues
 - Invest surplus oil savings abroad
- A well-designed petroleum fund can be a useful tool to support wise and long-term budget decisions
- Educate the public

Some lessons on fund management:

- Don't move too fast
 - It takes time to build a competent organization
 - Gradual evolution of investment strategy to make sure risk is understood and managed well
- Don't take more risk than you can carry
 - The worst mistake you can do is to be forced to sell after you have lost money
- Your returns over time are determined by strategy – not by active management
 - You cannot outsource the decision on how much risk to take
- Clear division of responsibilities
- Transparency
 - Legitimacy
 - Reduced risk of corruption and mismanagement

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Links

Ministry of Finance

- www.government.no/en/dep/fin

Government Pension Fund

- www.government.no/gpf

Norges Bank Investment Management

- www.nbim.no

Council on Ethics

- www.etikkradet.no