MEFMI COMBINED FORUM FOR MINISTERS OF FINANCE AND CENTRAL BANK GOVERNORS

Lima, Peru
October 6th, 2015

Transforming Depleting Natural Resources into Income for Growth

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KEY QUESTIONS TO PONDER DURING THIS SESSION

1. *What are the appropriate governance and policy frameworks that are necessary in order to ensure maximum value added from the exploitation of the natural resources wealth, so as to avoid the boom and bust cycles given the high volatility of commodity prices?*

2. *What are the principles guiding the spending of the commodity revenues efficiently, balancing between investing in today's needs vs. building a portfolio of financial assets that provides savings for future generations and/or to generates alternative sources of income different from non-renewable resources?*

3. *What are the best practice institutional and governance arrangements guiding the successful set up of long term savings funds across countries?*

ROAD MAP

1. Key challenges for commodity countries
2. Policy choices in response to the challenges
3. Institutional Arrangements for managing long term savings

ASSET TRANSFORMATION – FROM NATURAL RESOURCES TO GROWTH

Governments desire to turn the revenue from natural resources into outcomes that matter for their citizens: better health, better education, better infrastructure and access to quality social services

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ASSET TRANSFORMATION – FROM NATURAL RESOURCES TO GROWTH

Discovery | Production | Revenue | Public Investment | Human Development

Monetization: Produce, pipe, liquefy, sell, and ship the gas

Transfer rent: Through royalties, production shares, fees, acreage, dividends and corporation tax.

Public finance management: the budget

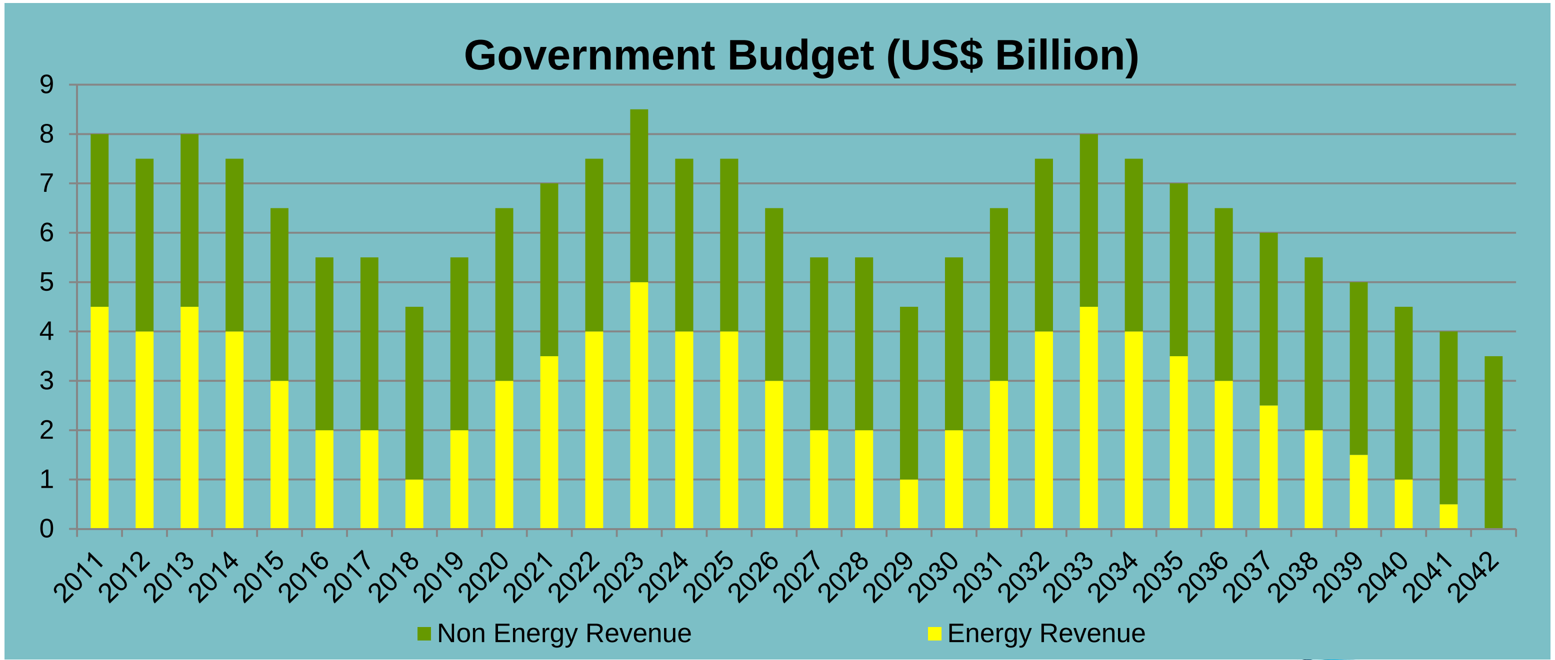
Policy and prosperity: How does public policy contribute to accelerated accumulation of human capital, productivity and welfare?

Source: “Natural resource revenues and macroeconomic policy choices”, African Development Bank and Bill and Melinda Gates Foundation, June 2015

KEY POLICY CHALLENGES FOR NET COMMODITY EXPORTERS

Countries that are highly dependent on the export of commodities are exposed to three key policy challenges:

- ✓ Stabilization to avoid boom and bust cycles given the high volatility of commodity prices.
- ✓ Saving for future generations and/or to generate alternative sources of income different from non renewable resources.
- ✓ Spending commodity revenues efficiently: balance between investing in today's needs vs. building a portfolio of financial assets



ROAD MAP

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ACHIEVING CONSENSUS ON THE USE OF REVENUES IS THE HARDEST CHALLENGE

The decision on how much to spend or save involves a difficult agreement at a national level that depends on:

- ✓ The size of projected revenues: Non commodity and commodity revenues (*total expected production * long term price assumption*)
- ✓ The deployment of these revenues for the purposes of stabilization, saving and spending to promote long term fiscal stability based on the analysis of many variables such as:
  - The absorptive capacity of the economy to efficiently invest revenue
  - Opportunities to diversify away from non renewable sources of revenue
  - The sensitivity of revenues to the expected volatility of commodity prices
  - Concerns on Dutch disease
  - Demographic trends and Inter-generational equity – maximize the sum of utilities of all the generations stretching to the infinite horizon

SPEND/SAVINGS TRADEOFFS

1. Combining moderate increases in public spending with a medium/long term strategy for national savings may complement fiscal policy as follows:
   - ✓ Reduce the impact of the resource revenue volatility on the budget;
   - ✓ Mitigate against the macroeconomic impact of large FX inflows;
   - ✓ Smooth the spending over time – in line with the spending capacity of implementing agencies; and
   - ✓ Help to promote inter-generational equity.

2. Spend/save of the resource revenues should be guided by the changing commodity prices and exogenous production variables

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DESIGN COMPONENTS OF THE LONG-TERM STRATEGIC OBJECTIVES

Non-commodity Revenue

Commodity Revenue

Long Term Fiscal planning

Structural surplus goal

Saving and spending rule

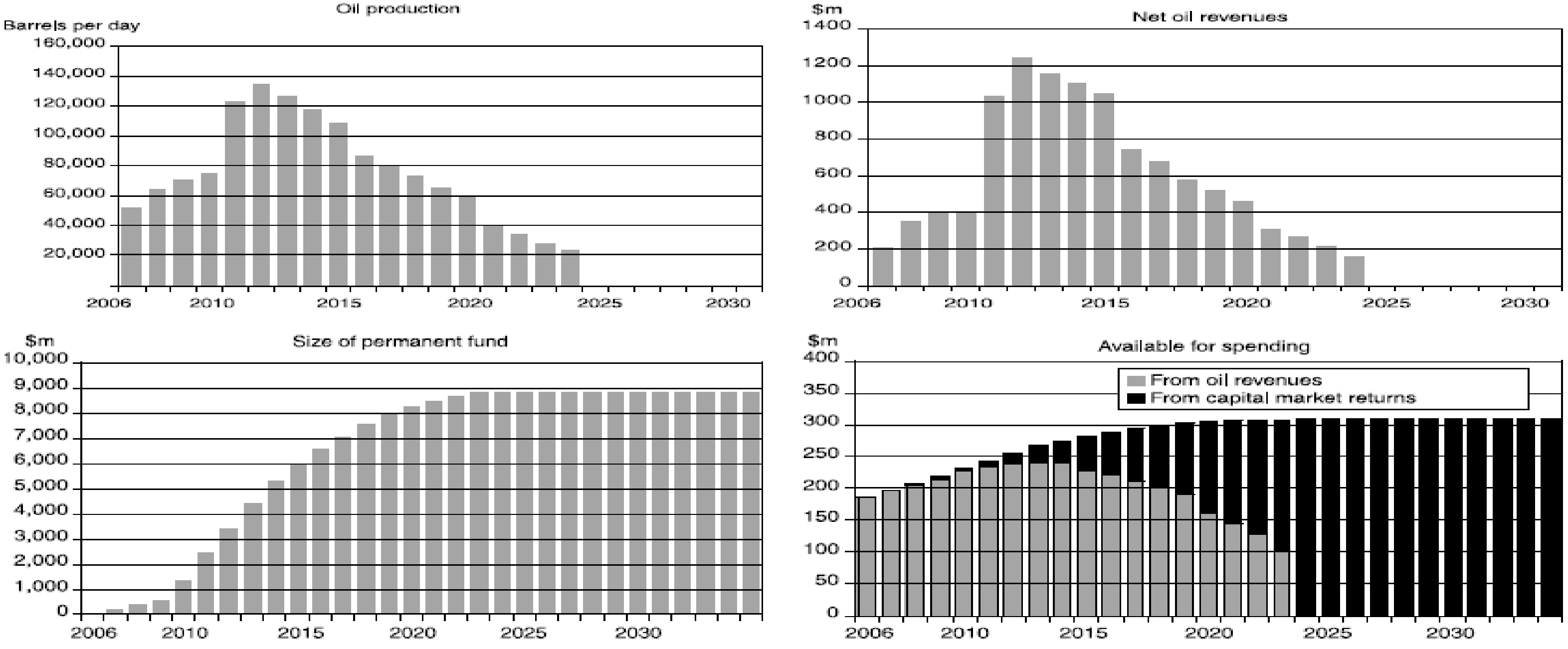
- Demographic trends
- Absorptive capacity of domestic economy
- Diversify Revenue sources
- Reduce Income volatility derived of price changes
- Avoid Dutch disease
- Inter-generational equity

Type of fund, e.g.: stabilization, savings, other

TRANSFORMATION OF DEPLETING RESOURCES INTO PERMANENT INCOME

In order to address depletion of the finite commodities, achieve intergeneration equity transfer and insulate domestic economy, the resource revenues may be accumulated and invested in foreign financial assets (and not in domestic assets)

Figure 4.3 Transformation of oil production into permanent income*



* The values expressed in these and subsequent figures are expressed in real terms (ie 2005 dollars).

Growing stock of financial assets to be used to finance the country's future fiscal/financial needs

Source: J. Johnson-Calari, A. Berkelaar, "Commodity Funds for the Future", RBS Reserves Management Trends 2006

POLICY CHOICES ON THE USE OF REVENUES WILL DETERMINE THE TYPE OF SAVINGS FUND

The critical design feature is the procedure to determine transfers and withdrawals to meet the long term objectives, which formalizes the decision on how much to spend or save

Objective	**Type of Fund**
Smoothing budgetary cycles.	Stabilization
Ensuring Intergenerational equity	Future
Preserving capital to generate alternative sources of revenue different from non renewable resources	Endowment
Meet long term contingent liabilities	Special purpose Fund

The savings and withdrawal rule should be based on the analysis of a sustainable long term public spending path

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EXAMPLES OF SWFS

Objective	Examples of sovereign wealth fund
Macroeconomic stabilization	Abu Dhabi Investment Council Chile Economic and Social Stabilization Fund Kazakhstan National Fund Mongolia Fund (tentative) Russia National Welfare Fund
Future generation savings	Alaska Permanent Fund (U.S.) Alberta Heritage Savings Trust Fund (Canada) Australia Future Fund Azerbaijan State Oil Fund China National Social Security Fund New Zealand Superannuation Fund Norway Government Pension Fund–Global Permanent Wyoming Mineral Trust Fund (U.S.)
Management of government holdings	Mubadala Holdings (UAE) Tamasek Holdings (Singapore)
Wealth and return maximization	Abu Dhabi Investment Authority China Investment Corporation Government of Singapore Investment Corporation Korea Investment Corporation

Sources: Milken Institute, JPMorgan Research.

DOMESTIC VS FOREIGN INVESTING

There is growing interest in domestic investing. Some of the arguments supporting this view:

1. Mobilizing domestic savings to finance long-term infrastructure projects
2. Domestic investments could be used to promote economic diversification and offset Dutch-disease effects by boosting the competitiveness of key non-resource sectors such as agriculture, and also to expand access to finance by SMEs
3. Returns to investment in the domestic market may be higher than investment in foreign assets, particularly if positive economic and social externalities such as the impact on job creation are considered

CHALLENGES OF INVESTING IN DOMESTIC ASSETS

1. Macroeconomic challenge of managing Dutch decease

2. Vulnerability of the governance structure to political interference
   - ✓ No precedent for a successful SWF with authority to invest domestically in a weak institutional environment

3. Conflict between development and investment objectives
   - ✓ Development vs. commercial investment require different institutional arrangements, investment processes, governance structures, skills and hr policies

Possible alternative: a three-tier structure:

- ✓ SWF invests exclusively in foreign assets
- ✓ Government-owned holding company for investment in infrastructure (funded through the budget)
- ✓ Public venture capital fund to fund SME and upstart companies (funded through the budget)

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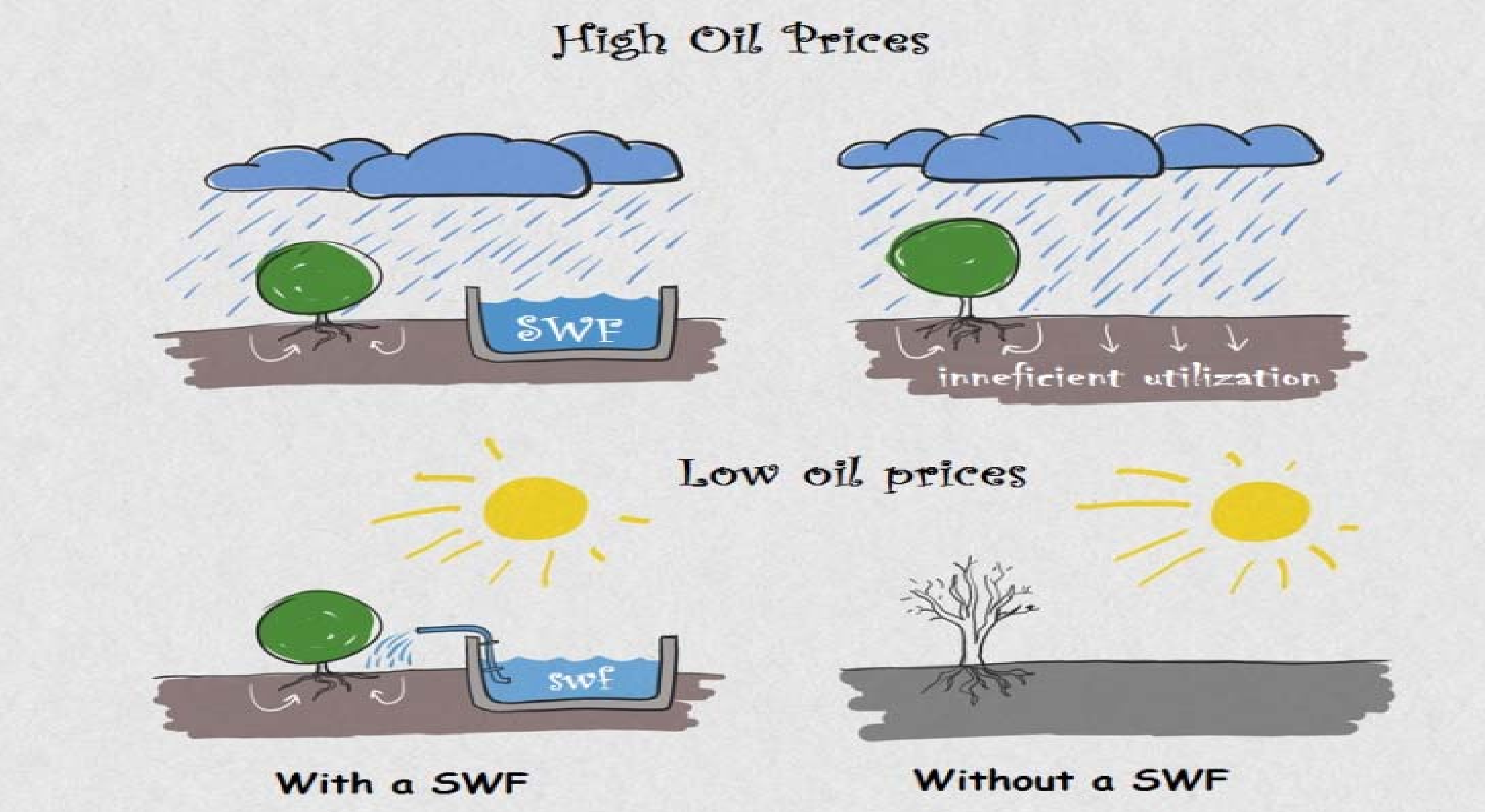
WHAT WILL HAPPEN WHEN THE GOOD TIMES COME TO AN END?



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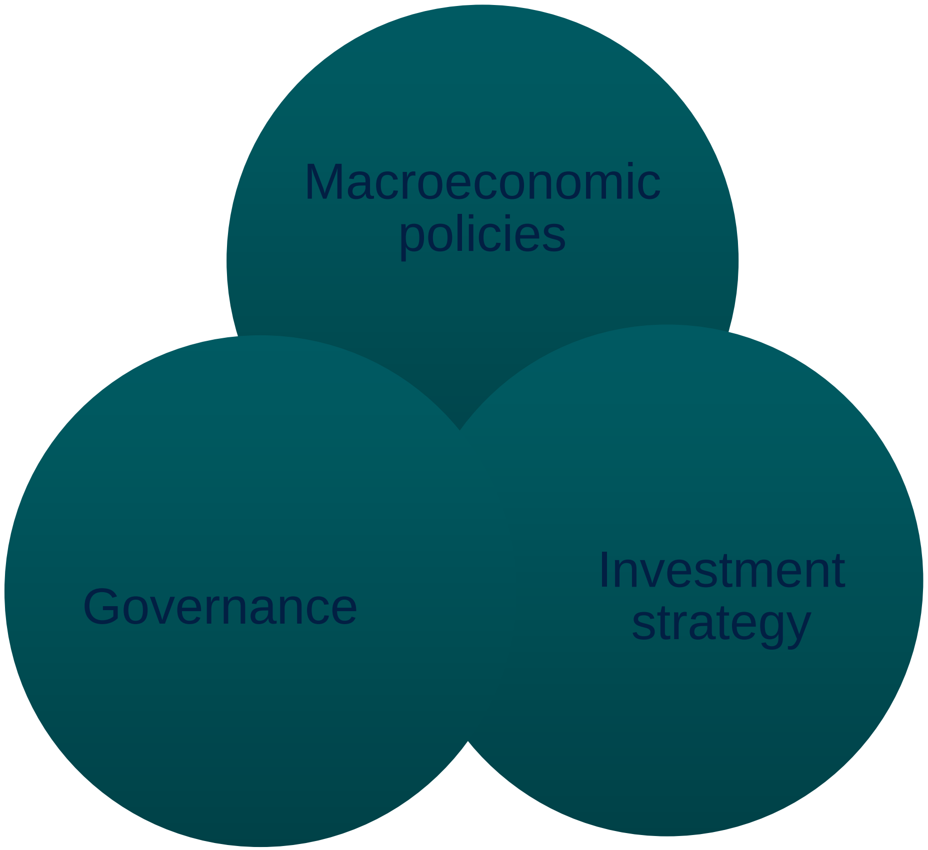
THREE MAIN ELEMENTS OF A SAVINGS FUND POLICY



Source: Martin Skanke, former Director General of Norway's Ministry of Finance Asset Management Department

THE THREE ELEMENTS ARE INTERDEPENDENT

1. Macro policy and investment strategy
   - Optimal strategy contingent on macro role of fund
2. Investment strategy and governance
   - The complexity and risk of the strategy will determine the need for robustness in governance
3. Governance and macro policy
   - The governance structure must give sufficient legitimacy to justify accumulation of assets

Source: Martin Skanke, former Director General of Norway's Ministry of Finance Asset Management Department

KEY INSTITUTIONAL RISKS FACING LONG TERM SAVINGS FUNDS

A key challenge that faces savings funds over time is the conflict between their strategic objectives and short term political objectives as can be reflected in the following risks:

1. Direct raiding: funds are used for purposes other than originally intended or ex-ante contributions are not paid;
2. Indirect raiding: unsustainable fiscal behavior e.g. excessive debt accumulation on the back of fund's resources; and
3. Inefficient management of the funds: constraints on investments that are inconsistent with the fund's long-term objectives because of reputational risk concerns.

THE INSTITUTIONAL ARRANGEMENTS FOR MANAGING LONG TERM PUBLIC FUNDS

The institutional arrangements cover a wide spectrum of possibilities to balance two competing demands:

1. The need to ensure stake holder representation to design appropriate investment policies at the highest level of decision-making; and
2. The need to build a specialized financial management infrastructure to efficiently implement policy decisions.

SANTIAGO PRINCIPLES SET OUT KEY GUIDING PRINCIPLES

- The soundness of the legal framework to enable the Fund to accomplish its stated objectives
- The strategic objectives of the Fund should be clearly defined and publicly disclosed, in particular the criteria that governs savings and withdrawals
- Transparent disclosure of investment objectives, strategy and risks
- The institutional arrangements for managing the funds should be shielded from political interference and facilitate the efficient management of the funds to achieve their objectives
- Independent, knowledgeable and effective oversight mechanisms should be in place

SOME FUNDAMENTAL GOVERNANCE PRINCIPLES

1. Clarity of institutional objectives formulated in the legal mandate

2. Informed policy-making
   - ✓ Includes ownership of the risk/return profile of the portfolio at the highest level of sponsorship

3. Clear delegation of authority and accountability for implementation to a specialized asset management entity

4. Effective controls and oversight supported by well-recognized standards of prudential care

5. Transparency and communication

A GENERIC SWF GOVERNANCE MODEL

GOVERNANCE ARRANGEMENTS

1. The governance arrangements to manage long term funds cover a wide spectrum of possibilities, with varying degrees of independence from government, in order to balance two competing demands:
   - ✓ Informed policy making and ownership of the risk/return profile of the portfolio to meet its strategic objectives at the highest level of sponsorship; and
   - ✓ Delegation of authority and accountability for implementation to an specialized financial management entity.
2. The lack of an appropriate framework to segregate policy decisions from implementation can lead to imposing inefficient constraints on investments that are inconsistent with the investment horizon and risk tolerance

GOVERNANCE: WHO MAKES WHICH DECISION?

Strategic Decisions

Decisions taken less frequently

Policy Makers
Determination of investment policy principles that should govern the management of the funds to achieve long term objectives.

Investment Committee
Translation of policy principles into Benchmarks and Investment Guidelines.

Management Department
Portfolio management in compliance with the approved Investment Guidelines.

Decisions on implementation

Decisions taken more frequently

EXAMPLES OF GOVERNANCE ARRANGEMENTS FOR THE MANAGEMENT OF SWFS

1. Strategic asset allocation ownership at the highest level:
   - ✓ Ministry of Finance: Norway, Chile, Russia;
   - ✓ Investment Committee of financial experts and political representatives: Alberta, Trinidad & Tobago; and
   - ✓ Independent Board appointed by MoF following the recommendations of a nominating committee: New Zealand.
2. Delegation over implementation to a specialized entity:
   - ✓ In the Central Bank in a specialized asset management division e.g. Norway, Trinidad, Chile, Russia; and
   - ✓ Separate Agency managed at arms-length from government : New Zealand, Libya, Singapore.
3. Independent oversight mechanisms
   - ✓ Government Auditors, supervisory authorities and external auditing firms.

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KEY MESSAGES (1)

1. The macro-economic impact of natural resources booms for developing nations poses well documented challenges:
   - ✓ Need for fiscal stabilization to avoid boom and bust cycles
   - ✓ Need to generate alternative sources of income different from non-renewable resources.
   - ✓ Need to save for future generations
2. A key policy choice is to design an appropriate fiscal framework, comprising appropriate fiscal targets and rules that guide public spending/saving, to ensure fiscal sustainability
3. While investing domestically may foster economic growth, bot macroeconomic constraints can place a cap on the level of domestic investments

KEY MESSAGES (2)

4. The Santiago Principles set out good practices for overall governance and inform the key policy considerations in the management of natural resources
5. There is no single right model for the institutional set-ups to manage a country's SWF and the country specific context matters. Guiding principles may include
   - ✓ Institutional mandate and the fund(s) objectives
   - ✓ Institutional autonomy and independence from political interference
   - ✓ Legitimacy and operational capacity
   - ✓ Legal and sovereign immunity issues
   - ✓ Ability to attract and retain qualified staff

KEY MESSAGES (3)

5. The institutional arrangements to manage long-term savings funds cover a wide spectrum of possibilities to balance competing demands:
   - ✓ The need to ensure stake holder representation to design appropriate investment policies at the highest level of decision-making; and
   - ✓ The delegation of authority and accountability for implementation, including the need to build a specialized financial management infrastructure to efficiently implement policy decisions.

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