Session #20: Public Financial Management for Deep Sea Minerals (DSM)

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Outline

- The Resource Curse
- Macroeconomic Implications
- Mineral Revenue Management – Challenges
- 10 Recommended Principles and Practices for DSM Revenue Management
- Summary

Natural Resources: a Blessing or a Curse?

Blessing

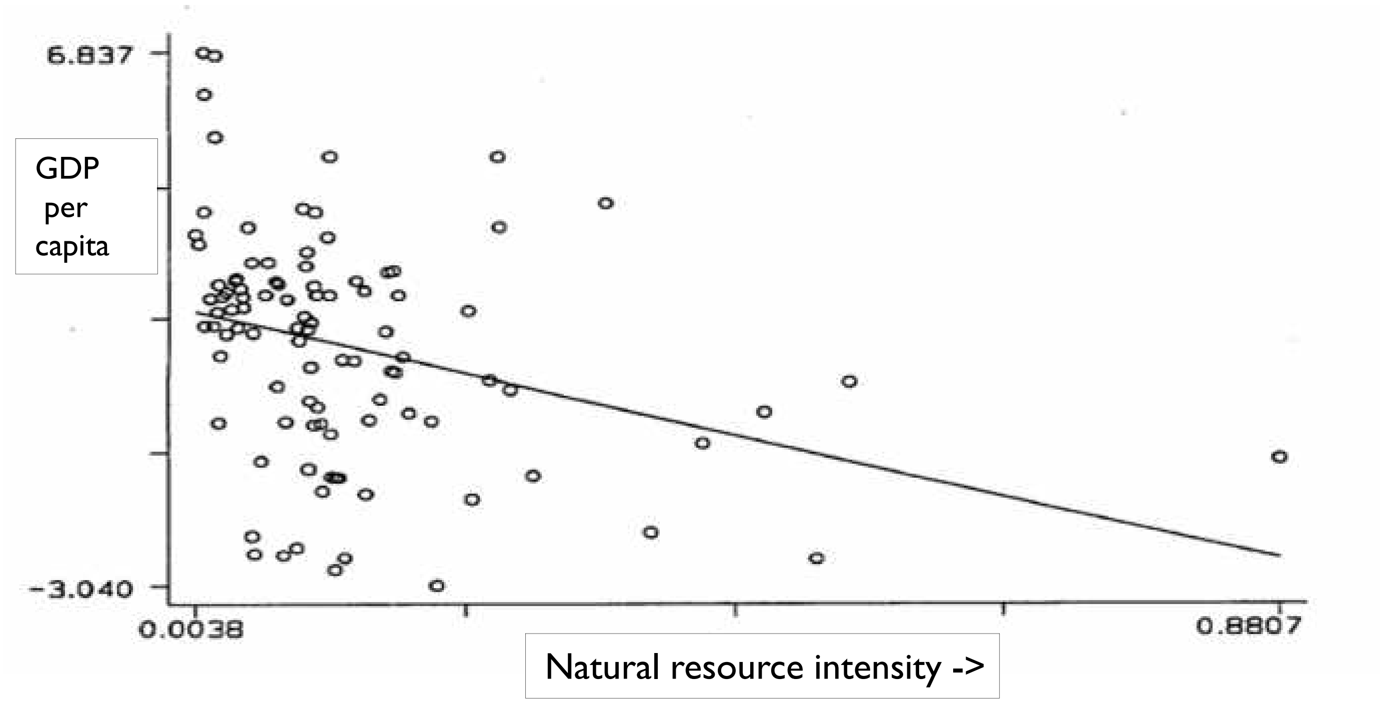
- A gift from mother nature
- Will improve the standard of living for the population, if managed wisely.
- Can be a catalyst for faster economic growth by lifting investment in infrastructure (roads) and human capital (education, health), which again will give rise to further wealth creation.

Curse

- International experiences give reason for serious concern ("the resource curse"):
  - ✓ Poverty and lower economic growth
  - ✓ Conflict, war and corruption
  - ✓ Unrepresentative government
- Can make the economy more vulnerable to instabilities and cost pressure.
- A tendency to regard the mineral revenues as "free money".
- Easy to lose focus on what is most important in terms of creating economic growth.

The Resource Curse

- A paradox that countries well endowed with non-renewable natural resources tend to have less economic growth and development than countries less equipped with natural resources.
- GDP/capita 1970-89 vs. share of natural resource export in GDP in 1971 for 97 developing countries:



Source: Sachs and Warner (1995)

Macroeconomic Implications

- The benefits
  - employment and development of new industries
  - funds for public investments: infrastructure and investment in human capital
  - giving a potential for sustainable economic growth & increased living standard

- The potential risks
  - inflation from an over-heated economy
  - exchange rate appreciation and excessive wage growth
  - macroeconomic instabilities
  - crowding out of other sectors of the economy

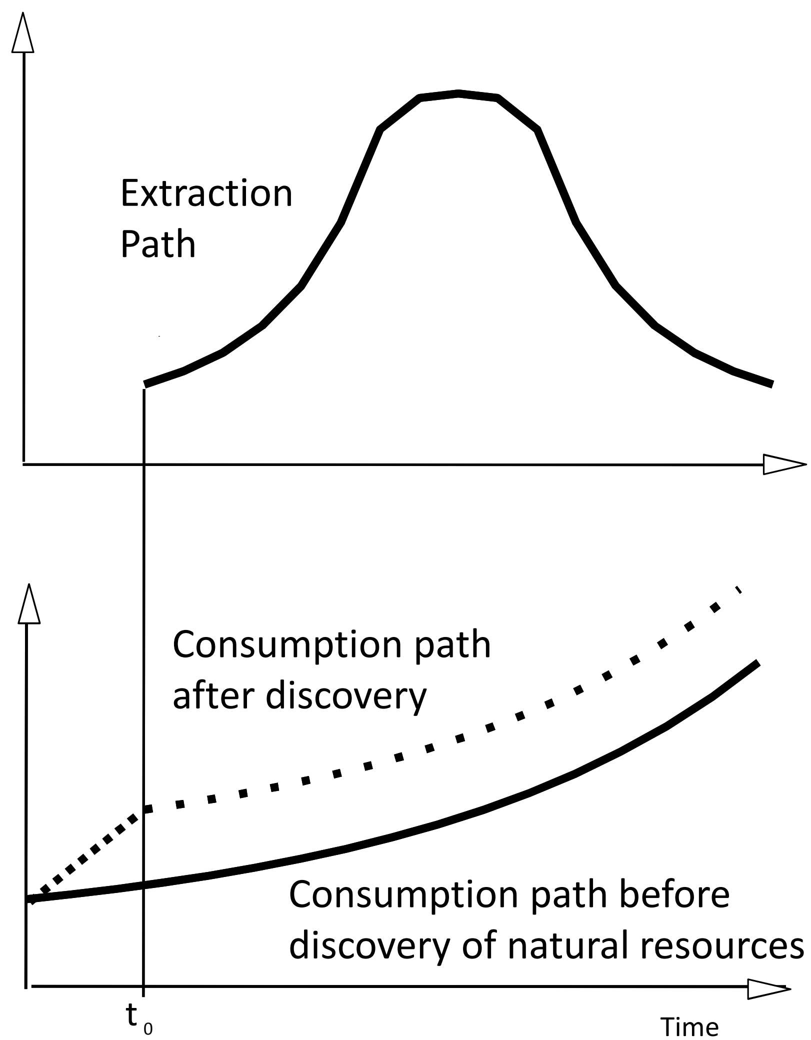
Mineral Revenue Management: Challenges

- By nature, minerals are exhaustible.
- Mineral revenues are highly volatile.
- Government spending financed through mineral revenues has a different impact on the domestic economy.
- Mineral revenues influence the real value of the currency and have an adverse impact on the non-mineral tradable sector (Dutch disease).
- Structural policy tends to be neglected in mineral abundant economies.
- Capacity constraints and bottlenecks make it challenging to efficiently transform mineral revenues into productive investments and lasting benefits.

Mineral Revenue Management – from Theory to Practice

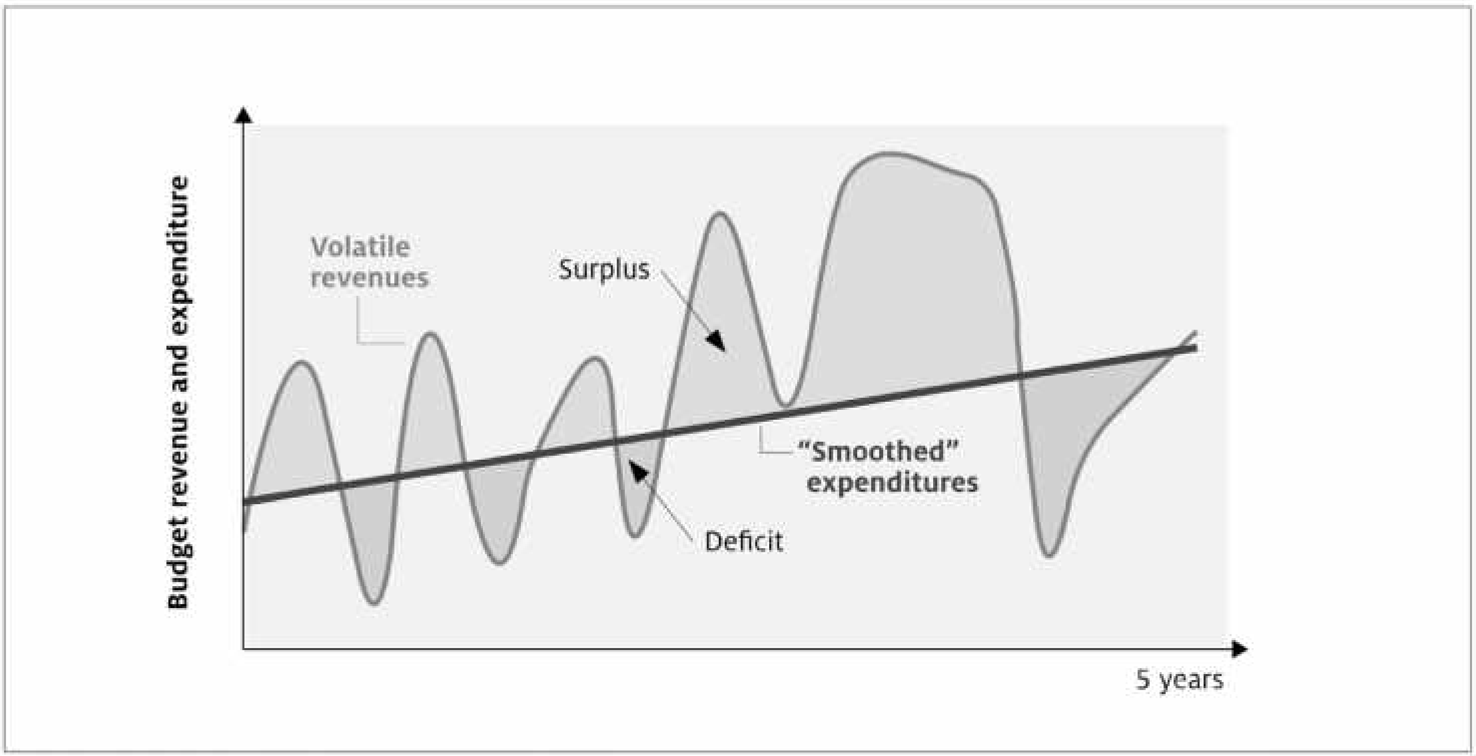
- **Short and medium-term stabilization:**
  - Necessary to separate mineral revenues from public spending.
  - Enables a stable macro-economic development.

- **Long-term savings:**
  - Enables future generations to benefit from finite mineral resources.



The Essence of Revenue Management

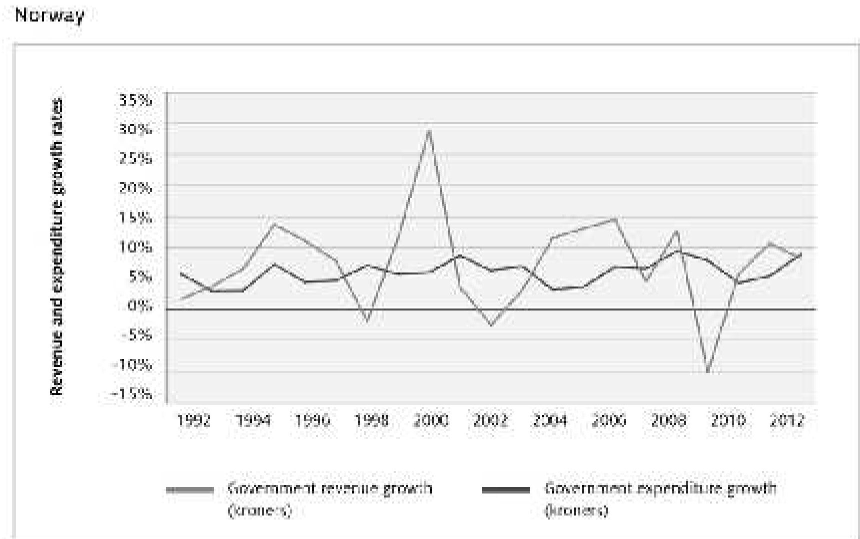
Public expenditures should be smoothed out and separated from volatile revenues.

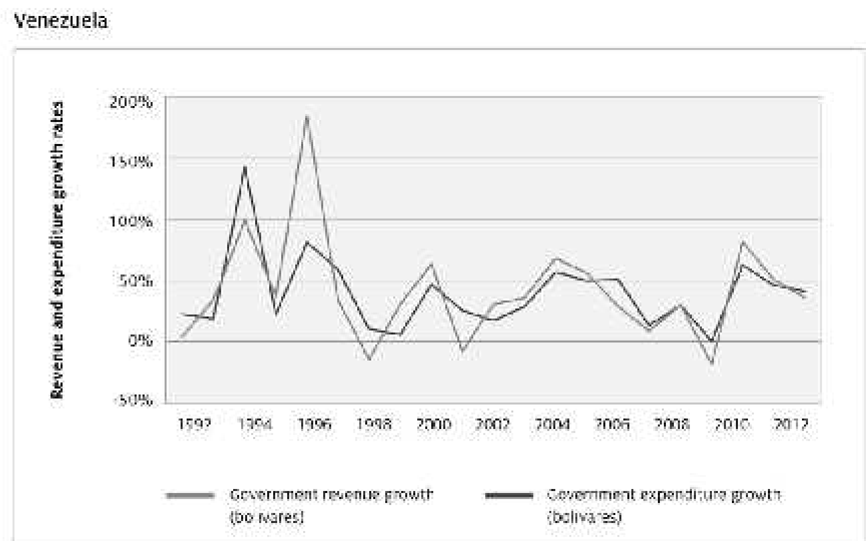


Source: Revenue Watch Institute

Two Practical Examples: Norway and Venezuela

- Norway has established a Sovereign Wealth Fund, the Government Pension Fund Global (GPFG), and a fiscal policy guideline that enable a smooth public expenditure path and stable macro-economic development.
- Venezuela does not have such framework in place. The economy is, to a large extent, subject to huge volatility in petroleum revenues.





Source: Revenue Watch Institute

10 Recommended Principles and Practices for DSM Revenue Management

1. Build broad based **consensus**. Consensus among key stakeholders is a prerequisite for a sustainable framework.
2. Ensure **transparency** in all parts of the value chain – from revenues are received until disbursement. This would build trust and prevent perception of poor management.
3. Establish **clear objectives** that can guide the design and operationalization of the framework.
4. Establish clear divisions of duties to ensure adequate **checks and balances**.
5. Apply **fiscal discipline** and abide by the agreed framework.

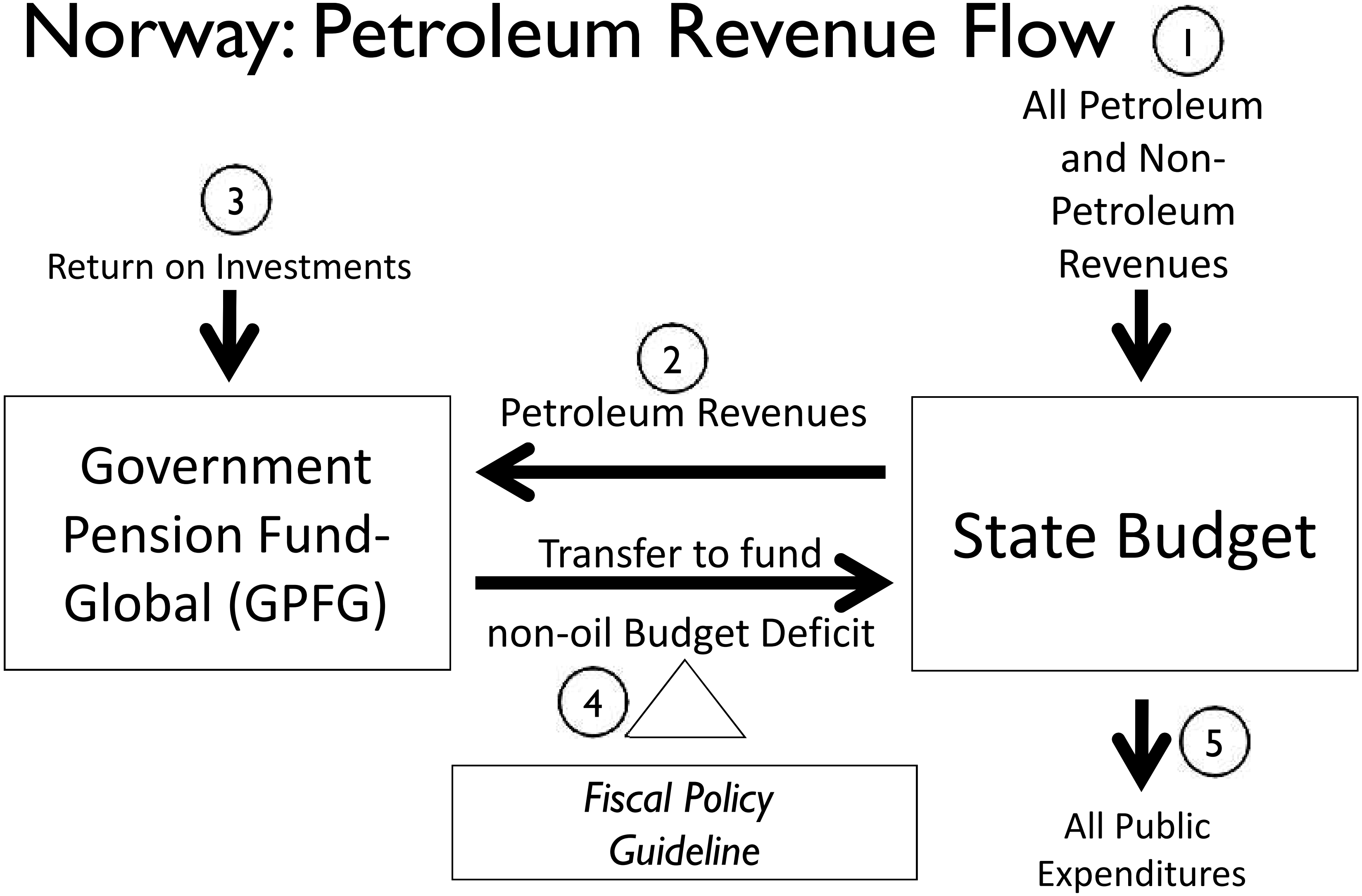
10 Recommended Principles and Practices for DSM Revenue Management

6. Integrate mineral revenues comprehensively into the **macroeconomic and budget framework** so that all decisions regarding revenue management are considered in a broader economic context.
7. Separate mineral revenues from public expenditures by establishing **stabilisation/savings mechanism(s)**.
8. Establish a **fiscal policy guideline** that guides the savings/spending decision.
9. Spend mineral revenues through the **national budget**.
10. Save mineral revenues in the **international financial market** in order to avoid adverse impacts on the domestic economy.

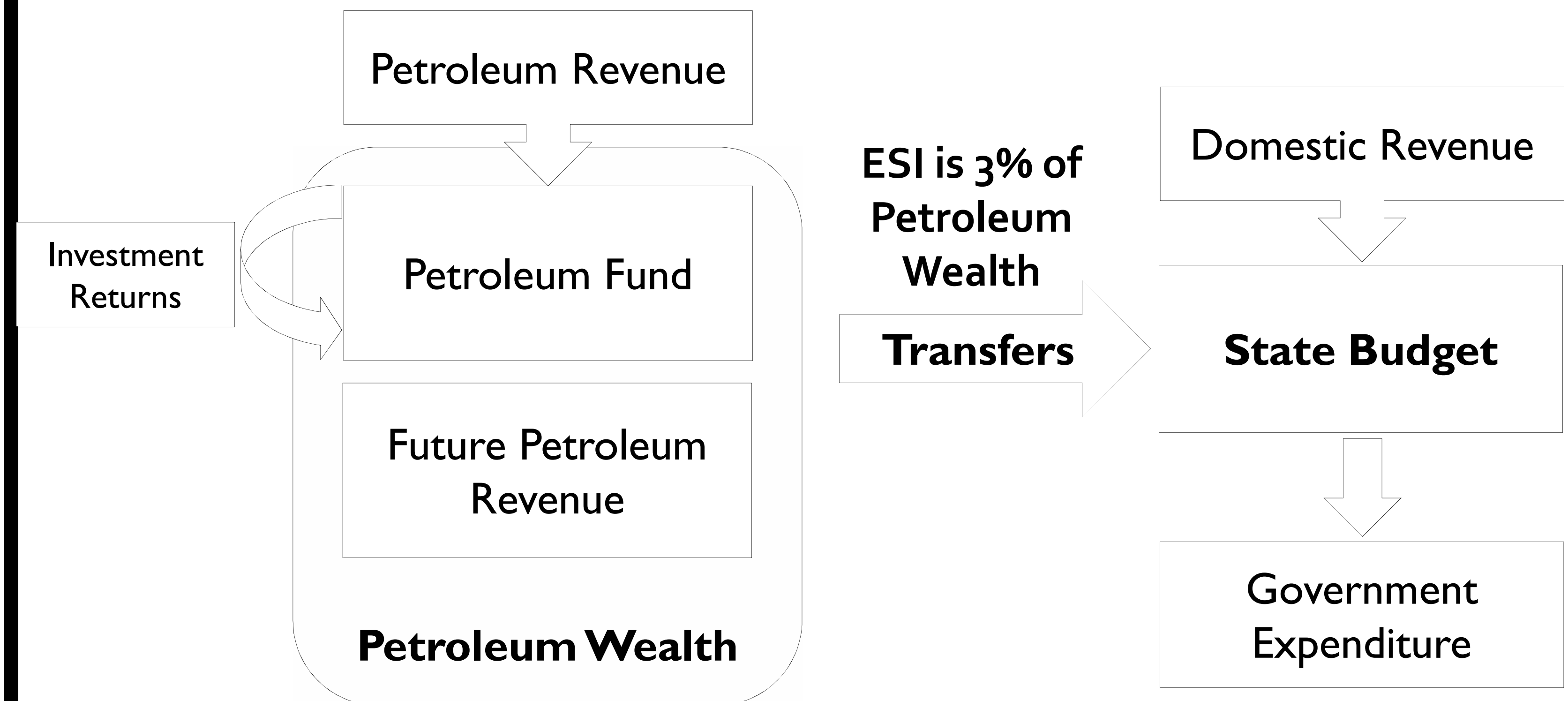
How much to spend? How much to save?

- The savings/spending decision and the institutional set up are two separate discussions.
- Investing domestically to diversify the economy and promote economic growth may be wise, provided that:
  - the return on domestic investments is higher than the financial return abroad.
  - the domestic economy can absorb additional spending without facing adverse effects.
  - the government has adequate capacity to spend wisely.
- However, spending should take place through a comprehensive budget process in Parliament – not by the SWF.

Norway: Petroleum Revenue Flow



Timor-Leste: Estimated Sustainable Income (ESI)



Fiscal Policy Guideline Options

- Balanced budget rule
  - Limit on structural non-mineral budget (Chile, Mongolia)
  - Bird-in-the-hand rule (Norway)
- Debt rule
  - Public debt as a percentage of GDP (Mongolia)
- Expenditure rule
  - Limits on spending in absolute terms, growth rates or in percentage of GDP (Botswana, Mongolia)
- Revenue rule
  - Permanent Income Rule (Timor-Leste)
  - A cap on how much of revenues that can be spent, for example based on a benchmark price (Ghana)

A fixed rule or a policy guideline?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Petroleum Fund of Timor-Leste
Establishment of the Petroleum Fund
The Petroleum Fund of Timor-Leste was established under the provisions of the Petroleum Fund Law, which was promulgated on 3 August 2005. The Petroleum Fund Law was amended on 23 August 2011.
The Petroleum Fund Law:
provides mechanisms that assist Timor-Leste to sustainably manage its petroleum revenue
details the parameters for operating and managing the Petroleum Fund
defines the asset allocation and risk limits
governs the collection and management of receipts associated with petroleum wealth
regulates transfers to the State Budget, and
provides for government accountability and oversight of these activities.
A Management Agreement between the Ministry of Finance and the Central Bank of Timor-Leste was signed in 2005. This was amended in June 2009 and its annex 1 was then amended in October 2010.
Petroleum Fund Investment
The Petroleum Fund Law requires that all petroleum revenues are entirely transferred to the Fund and invested abroad in financial assets. The Fund's only outgoings are transfers back to the central government budget, pursuant to parliamentary approval.
From 2005 to June 2009 the entire portfolio was managed by the Central Bank of Timor-Leste (formerly the BPA) and was invested in US Government bonds only.
In June 2009, the Bank for International Settlements (BIS) was appointed as the Fund's first external manager to manage 20 per cent of the total Petroleum Fund and invested in a broader range of Government and Supranational bonds.
In October 2010, Schroder Investment Management, the Fund's first equity manager, was brought in to manage global equity mandate amounting to 4 per cent of the total Petroleum Fund.
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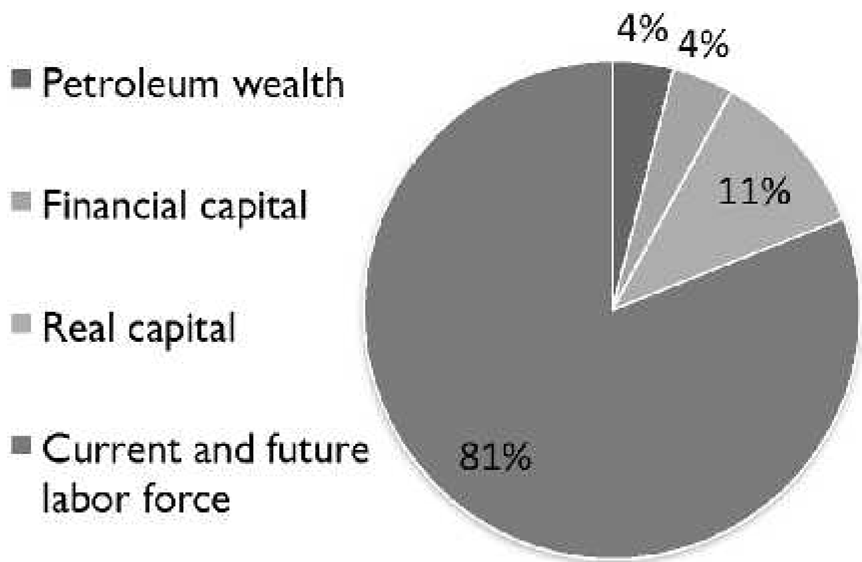
Focus on the Non-Mineral Sector is Paramount

- Norway's National Wealth: Petroleum is negligible compared to the labour force.
- Future economic growth can only be achieved through focus on non-oil sector.
- Health, education and other means to improve productivity are far more important than oil.



Source: Ministry of Finance, Norway

Summary

- Agree on objectives, encourage discussions and build consensus on the DSM revenue management framework.
- Think carefully about the design and organisation. Benefit from lessons learnt by others without replicating models elsewhere. The framework must suit your needs!
- Consider DSM revenue management in conjunction with your debt strategy. What counts is the country's net financial position.
- Promote maximum transparency. That is the best way to build confidence and avoid mismanagement and waste.
- Build capacity within government institutions and be aware the economy's absorptive capacity.
- Be patient and disciplined!

Take Away Points

- Draw on lessons learnt by others when designing the revenue framework.
- Put in place a revenue framework well in advance of when the revenues start flowing.
- Transparency and accountability is an absolute pre-requisite for success.