

A Petroleum Fund for Timor-Leste

Frequently Asked Questions

1. Why not organise the Petroleum Fund as a separate 'Trust Fund' (instead of integrating it with the State Budget)?
2. Why should the Petroleum Fund be integrated into the State Budget? And how can we ensure that spending is appropriate and channeled to areas of priority?
3. Why will the Petroleum Fund be invested in financial assets? Is it not better to invest in building the country?
4. Why is the Petroleum Fund to be invested abroad, supporting economic development in other countries instead of in Timor-Leste?
5. Why does the Petroleum Fund only save in financial assets like US government bonds, and not in other assets like large investments in some selected companies, property, art, football teams etc?

1. Why not organise the Petroleum Fund as a separate ‘Trust Fund’ (instead of integrating it with the State Budget)?

- To organise the Petroleum Fund as an independent ‘Trust Fund’, distanced from the regular budget and political process, will not in itself guarantee a good management of the fund. The Constitution states that sovereignty rests with the people, and that Parliament is the organ that represents all Timorese citizens and is vested with legislative and political decision making powers. It is difficult to argue that one democratically elected Parliament can constrain a later one. A later Parliament is free to pass its own laws, making it difficult to force good policy today through legislation alone.
- As a practical matter - unless the funds were transferred to a foreign sovereign state or entity in which Timor-Leste had no interest, it would be impossible to stop a future government from simply repealing the original fund law and using the money as it wished.
- Even if you do establish a separate fund and there is an accumulation of savings, this is no guarantee that money is being saved. If Government and Parliament feels too little money is available for spending, they are free to finance spending plans by borrowing.
- Borrowing can be used as a way to circumvent any limitations imposed by the fund. This would not only undermine the policy intention of such a trust fund, but it would also be non-transparent as the fund balance would not be a representation of the government savings. It is not normally wise to have the government saving money on the one hand and simultaneously borrowing at the same time.
- The bottom line is that it is virtually impossible to establish strict legislation and rigid rules that will guarantee a good policy. A bad government will almost always find a way to implement bad policies. This is the experience from other petroleum producing countries.
- We need the Petroleum Fund to contribute to sound fiscal policy, and it is good planning and execution of public sector budgets that are key to avoiding the resource curse found in so many petroleum producing countries. It is therefore best to acknowledge the status of the fund as a budgetary fund, establish the basis for moral suasion, build capacity and establish a broad consensus on the management of petroleum wealth through information, transparency and accountability. (See also Question number 2.)

2. Why should the Petroleum Fund be integrated into the State Budget? And how can we ensure that spending is appropriate and channeled to areas of priority?

- The budget process is the process by which the country makes decisions about what revenues to raise, what to spend and how to spend. This should be the case and a petroleum fund should not interfere with it. If there is a problem with the budgetary process, the problem should be fixed. Trying to get around it by adding a different budget process (the petroleum fund) is not the answer. In addition, it is not in accordance with the Constitution to have a State Budget which is not passed by Parliament or which contains secret appropriations or funds.
- It is more important to strengthen existing institutions instead of building new ones. Our Constitution assigns Parliament a very important role. The proposed Petroleum Fund strengthens Parliament, and also seeks to strengthen Parliament's capacity to legislate good policy. And who is supposed to decide on funding to areas of priority if not Parliament elected by the people?.
- Rigid budget rules to regulate policy are problematic. We may think we have the right rule now, but things change. There may be need for variations in spending due to a large infrastructure project, a natural disaster, or a war etc. We cannot fine tune and predict fiscal policy for the indefinite future.
- Rules are also problematic as they have to be monitored and enforced. There will always be problems with credibility and avoidance (see the EU growth and stability pact), and generally wasted effort in "complying".
- Parliament and government will always be able to change the rule in the future. Better therefore to recognise that Parliament and Government are sovereign, and strengthen the basis for good decision-making through a strong savings instrument and a guideline for "expenditure & savings policy".
- There are very few examples of good management of petroleum wealth and petroleum funds. One successful example is the experience of Norway. We have therefore chosen to build on the positive experiences of Norway, where a key feature is the integration with the State Budget and focus on the regular budget process, but then to create a Fund that is adapted to the Timorese reality.
- In addition, it is important to bear in mind that the question of the Petroleum Fund has been envisaged in the Constitution, more specifically in its Article 139. Paragraph 2 refers to "the establishment of mandatory financial reserves" in the case of those natural resources "which are essential for the economy". It is also prescribed by the Constitution that these resources "shall be used in a fair and equitable manner in accordance with national interest". What is in the "national interest" changes over time, and can only be determined by the legitimate Government and Parliament.

3. Why will the Petroleum Fund be invested in financial assets? Is it not better to invest in building the country?

- Large amounts of petroleum revenues will continue to be invested in Timor-Leste – building roads, improving education and providing better health care. This is done through the regular State Budget.
- The Government's newly adopted policy on expenditures & savings means that we are aiming to increase spending over the State Budget (CFET) by 1/3 in the next few years. Assumptions:
 - The policy is to maintain the real value of the petroleum wealth (PF+petroleum reserves in the ground).
 - This translates to spending the estimated sustainable income of the petroleum wealth, which by today's calculations is \$70 million per year. (3% real rate multiplied by \$2 343 million - the present value of the petroleum wealth)
 - Add to this \$30 million in domestic revenues, and sustainable spending is \$100 million. Spending was \$75 million last year.
- The Government's savings policy will bring both a sharp increase in spending and set aside money for the future, to benefit both this generation as well later generations in a balanced, equitable way.
- It will be very demanding to increase spending by this much, while also making sure it is spent wisely and not wasted. Those who say that spending should be a lot higher than this at present, underestimate the challenge to execute the budget properly and avoid waste.
- It is not the role of the Petroleum Fund to invest in infrastructure, health and education. This is the role of the State Budget, proposed by the Government and passed by Parliament - as required by the Constitution.
- Timor-Leste can save by investing in 'physical assets' or 'financial assets'.
 - Investment in 'physical assets': done through the budget, determined by whether we are able to invest the money wisely (good returns).
 - Investment in 'financial assets': in the Petroleum Fund. Amount of savings reflects budget decisions (on consumption and investment in physical assets).
- Although one can identify many areas in need of more money, we must not forget to see this in relation to what we can afford. Spending lots of money a few years, which later will force spending to be cut sharply, is not a desirable development.
- Petroleum extraction is a depletion of a non-renewable resource. Petroleum revenues are not really income, but a transformation of assets from petroleum resources to cash. A policy of saving money in the Petroleum Fund means that our children can enjoy the petroleum wealth as well.
- Experiences from other petroleum producing countries show that it is wise to save money (in a fund).

4. Why is the Petroleum Fund to be invested abroad, supporting economic development in other countries instead of in Timor-Leste?

- The Petroleum Fund is invested abroad because it is good for Timor-Leste, not because we want to support development in other countries. Experiences from other petroleum producing countries show that it is best to save the money abroad.
- It is not only money that is needed for Timor-Leste to achieve strong and sustainable growth, but good policies, a good regulatory environment, building institutions, improving education, fostering entrepreneurship etc. (ie, raising the value of human capital).
- The financial assets of the Petroleum Fund would not deliver a better economic development for Timor-Leste if they are invested locally. What happens if we deposit the money with BNU, Bank Mandiri and ANZ? They are unlikely to substantially increase their lending (which is determined by the credit worthiness of their customers), but would probably instead invest the majority of the funds abroad. It is better that we do these investments abroad ourselves, saving the costs of the middleman.
- The Petroleum Fund will become very big. The Timorese economy is not large enough to absorb all the savings, so we must save abroad. The country as a whole can only save in financial assets by accumulating foreign assets. If the Petroleum Fund invests in domestic financial assets, either the private sector will invest abroad – or national savings will fall.
- Investment abroad reduces the risk of the Fund's investments – not all eggs in one basket. (All eggs in one basket means all eggs break if the basket falls.) Investment abroad reduces both the financial risk and the political risk.
- The financial risk is reduced by investing in a broad range of financial assets in markets that are well regulated and liquid, enabling you to sell your investments immediately if need be.
- The political risk is reduced by diminishing the scope for political considerations influencing the actual investment decisions, which could otherwise lead to poor returns and the emergence of bad governance and corruption. (The PM, Finance Minister and the BPA would be overwhelmed by businessmen presenting their investment ideas.) Another aspect of reduced political risk is the experience of Kuwait in 1991. Although Iraq invaded, the Kuwaiti government still had access to funds, since many of these were invested abroad.

5. Why does the Petroleum Fund only save in financial assets like US government bonds, and not in other assets like large investments in some selected companies, property, art, football teams etc?

- The Petroleum Fund is to be our savings account, our ‘piggy bank’. This means the money should be invested safely and in a way that we can easily get it if and when we need it to finance the budget. We should therefore avoid projects with high risk and uncertain returns (interest).
- Three important sources of risk we need to keep in mind are: currency risk, credit risk and interest rate risk:
 - Currency risk: Since we in Timor-Leste use the USD, we should as a starting point stick to investments in USD to avoid currency changes influencing the value of the Petroleum Fund.
 - Credit risk: The investments that typically carry the least risk of default are bonds (loans) issued by governments with a rock solid credit rating (for example US, Canada, Western-Europe). This means there is a very high probability that the government will pay back its bond (loan).
 - Interest rate risk: Normally one can achieve a higher interest rate if one buys a bond with a long duration until maturity than a short duration. But one also needs to keep in mind that changing financial market conditions result in changes to the levels of interest rates, which affect the value of the bonds if you want to sell them today. A bond investor should therefore as a starting point choose a bond whose maturity matches the time at which the investor needs the funds.
- A likely investment profile of the Petroleum Fund would probably be government bonds denominated in USD and with a duration somewhere between 1 and 5 years.
- Investment in equities/shares would not be suitable for Timor-Leste at this stage, since they tend to be more risky (the value of the assets vary more over time). If the Petroleum Fund grows and it is clear that there will not be much need of accessing the money in the short to medium term, it may make sense for Timor-Leste in a few years to investigate whether a moderate portion of equities would be a good idea. Similarly, it would be wise to review other aspects of the asset allocation (currency risk, credit risk and interest rate risk).
- Large stakes in selected companies (the government or some investor choosing companies they believe will do better than other companies) is not recommended. This also applies to property investments or other exotic investment suggestions (art, football teams etc). A government is typically not very good at choosing “winners”, this is a lesson learnt in very many countries.
- Experiences from other countries suggest an investment profile similar to the one we are proposing for Timor-Leste.