The Petroleum Fund and Development Strategy in Timor Leste

Outline of a Report for Timor Leste's
Petroleum Fund Consultative Council
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July 2010

Overview

Part A: The Petroleum Fund: management issues

1. Founding principles
2. Current Challenges
3. Particular Risk Factors for Timor Leste
4. Sovereign Wealth Funds and development
5. Fund Investment Reform Options
6. Institutional Implications

Part B: Development Strategy in Timor Leste

7. Development Strategies
8. Strategies in Timor Leste
9. Strategy, debate and the neglected sectors

1. Founding Principles

- Fund management is based on principles established by the *Petroleum Fund Law* 2005, in turn based on Article 139 of Timor Leste’s Constitution.
- These principles require that the nation’s natural resources be used “in a fair and equitable manner” and for the needs of “both current and future generations”.
- Operational mechanisms established by law set up a governance structure for the Fund, a regulated investment regime for its financial assets and a process for withdrawal of revenues.

2. Current Challenges

Current challenges for the Fund include

- the low return environment of a global recession,
- a restructuring global economy in which the US economy and the US dollar are becoming weaker.
- a ‘honeypot’ effect on the Fund, as it grows bigger. That is, the Fund is attracting more interest, and provoking arguments that its funds should be made available and used up more rapidly.

3. Particular Risk Factors for Timor Leste

- the state's extreme dependence on fund revenues
- the limited capacity of local financial managers, in the face of bolder but less accountable external managers.

Table 3.1: Combined sources budget – planned expenditure, 2010						
Fund source	PF finance	Donor funds	Domestic revenue	AA revenue	Treasury reserves	Total
$m	502	199	77	11	71	859
% of total income	58.4%	23.2%	9%	1.3%	8.3%	100

4. Sovereign Wealth Funds and development

- SWFs can assist development through mobilising savings, investing in human resources, infrastructure, and generating participation.
- A general trend towards diversification of assets in SWFs, although even wealthy countries take a cautious approach to risk.
- Despite similarities, SWFs vary in: financial scale; dependence on fund income; management expertise; and aims and objectives.
- Those which rely less on their SWF for finance can better afford to invest in infrastructure. Those with high levels of skilled personnel can better manage exposure to risk in volatile financial markets.
- Timor Leste’s PF is relatively small, has limited levels of financial expertise and the state has developed extreme dependence on PF revenue. Caution is advised in these circumstances..

Table 4.1: Notable features of select Sovereign Wealth Funds		
Name (year est.)	**$bn**	**Notable features**
Kuwait: Kuwait Investment Authority (1953)	202	The KIA, has set up a number of investment and property enterprises.
Singapore: GIC (1981)	247	The GIC manages the country’s savings in three corporations under the Ministry of Finance
Norway: NBIM (1990)	474	The NGIM, moved into equities (50% by 2008) but is heavily regulated and has strong investment expertise.
Australia: Future Fund (2006)	59	Manages government’s budget surplus. Invests in a range of assets, including up to 25% equities.
Brazil: Fundo Soberano do Brazil (2009)	9	Began with foreign reserves but may include oil funds. Aims to protect from financial crises. Emphasises bonds rather than equities.
Alberta, Canada: Heritage Fund (1976)	14	Invests oil revenues “for future generations”, to strengthen and diversify the economy. Invests in stocks, bonds, property and other.
Botswana: The Pula Fund (1996)	7	Invests excess diamond wealth ‘for future generations’. Requires withdrawals to be below 50% of budget and with minimal debt.
Venezuela: FONDEN (2005)	58	FONDEN finances public infrastructure projects. A network of other public banks also manage oil funds.
Trinidad and Tobago: HSF (2007)	3	The HSF uses oil to stabilise public finances and provide for future generations. Current investments are 80% in bonds 20% in equities.

5. Fund Investment Reform Options

- the status quo - 90% US bonds, 10% other
- 25-40%+ into 'equities' (Towers Watson)
- diversified bond investment
- other options
  - securities
  - equity in productive domestic monopolies
  - property

the Towers Watson option

"The key decision is the split between equity and bonds – everything else is second order … An allocation to equities of **at least** 25% is required to achieve a long term real return of 3%, the current ESI" (Ryan-Kane 2010: 14)

Table 5.3: The Argument for Equity Investment

	100% USG bonds	Current	25% US Equity	40% US Equity	60% US Equity	80% US Equity	100% US Equity
Geometric real return (% pa)	1.7	2.0	3.1	3.8	4.7	5.5	6.1

problems with the Towers Watson option -

- long term averages obscure the possibility of real losses (the long term? stock averages and investment choices?)
- Timor Leste has a high risk profile (extreme fiscal dependence + limited management capacity)
- past century of US bonds and equities not a good guide to the future (declining US 'equity premium', current uncertainties and displacement of US global position)
- diversified bond market not considered

Table 5.4: Equity returns in seven wealthy countries, 1900-2009							
	Italy	Germany	France	Norway	UK	US	Australia
Av real rates of returns, p.a.	2.07	2.98	3.07	4.14	5.28	5.88	7.5

diversified bond markets an intermediate option

- considering (i) different time frames and (ii) wider bond markets, makes the future in bonds look not so bad

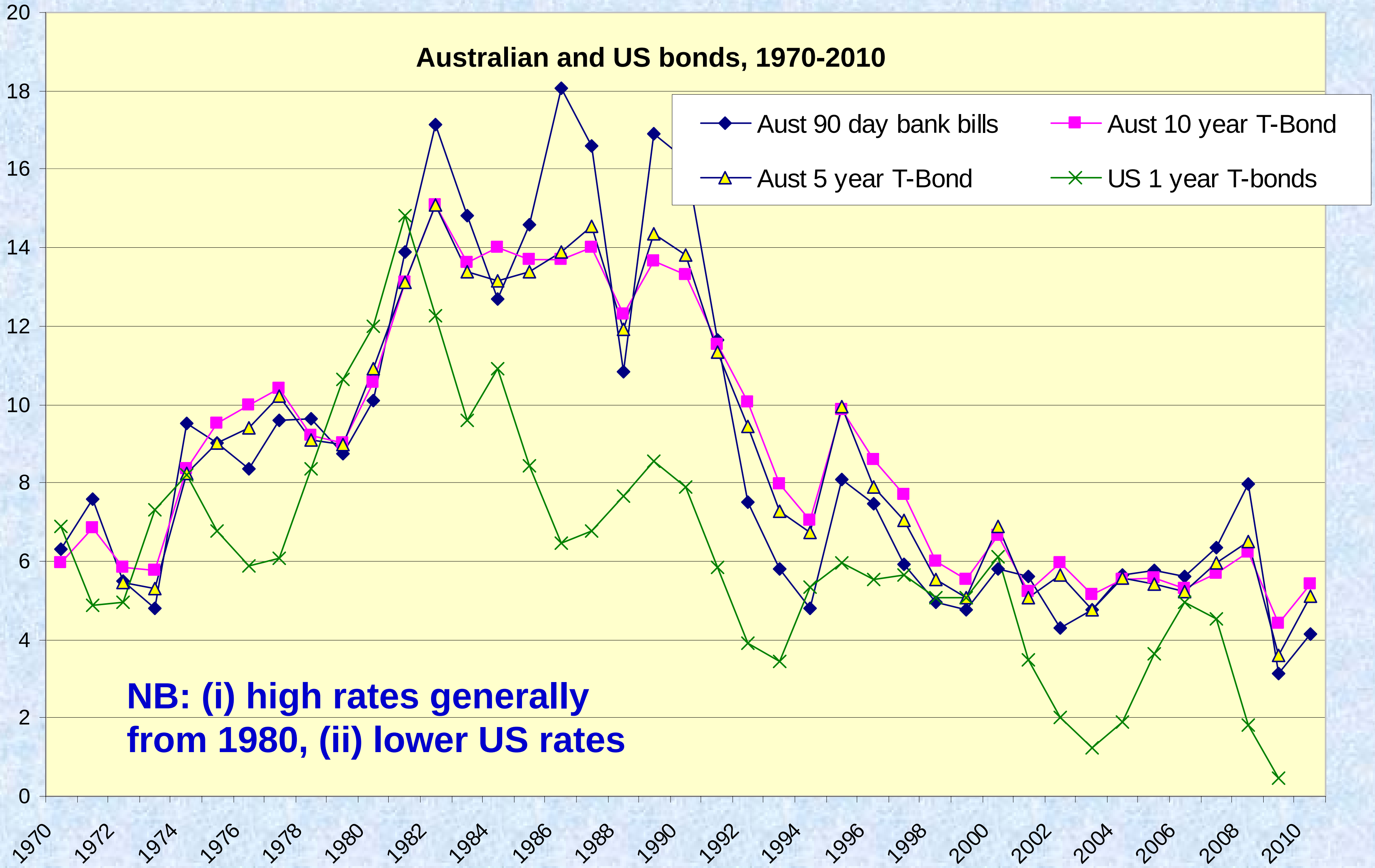
Table 5.1: Bond rates - distinct timeframes (average nominal rates)

	US T-bonds, 1962-2009, 3 year rates (1)	Eurodollar 6 month rates, 1971-2009 (1)	US Treasury 20 year bonds, 1926-1999 (2)	US Treasury 20 year bonds, 1972-1999 (2)
average return (% pa)	6.4	6.8	5.1	8.7

Table 5.2: Australian and US bonds, 1970-2010 (average nominal rates)

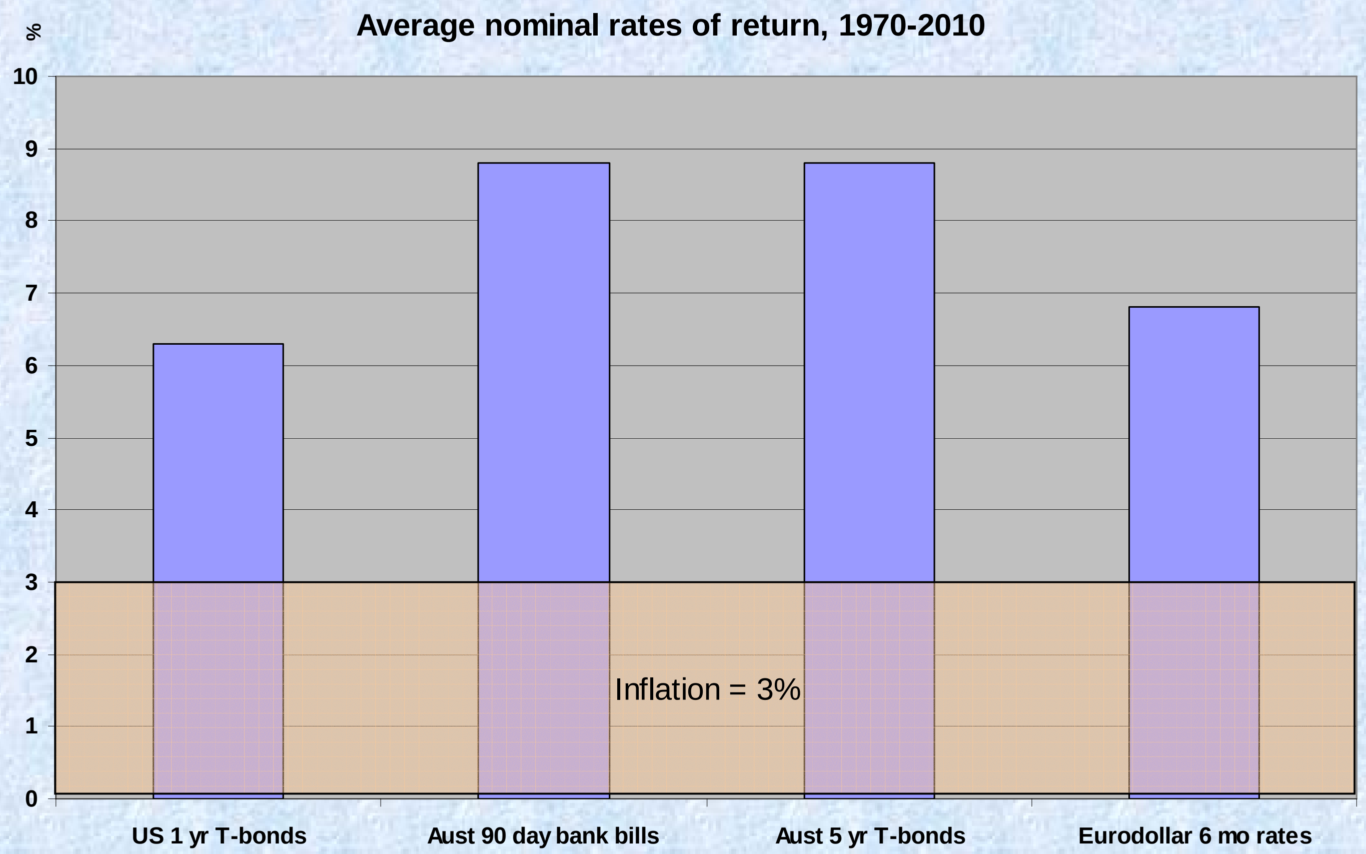
	Aust. 90 day bank bills	Aust. 5 year T-bonds	Aust. 10 year T-bonds	US 1 year T-bonds
Average returns (% pa)	8.8	8.8	8.9	6.3

US T-bonds and Australian bonds, 1970-2010



Based on the last 40 years, and depending on inflation, a 3% ESI **is attainable** through bond investment - but better options outside US bonds

Recent Euros returns > US$; Chinese Yuan bonds = Australian rates



other investment options:

- equity in 'productive domestic monopolies' (PDMs: telecom, banks, gas refinery)
- property (domestic and foreign rents)
- securities - on-selling assets into financial instruments (e.g. CDOs, 'junk bonds')

summary: investment options

The status quo

No change would mean priority for asset protection and prudent control. Still room to make use of the 10% for other investment options. However as returns are likely to remain low, consider lowering the ‘ESI’ (or government withdrawals) to 2%.

Diversified bonds

Diversified bonds retain the prudential approach of the current regime, while allowing investment in non-US bonds. An actual 3% real return is attainable. Room within the remaining 10% for more diverse investment. Changes to Articles 14 & 15 required.

'Diversified bonds plus'

‘Diversified bonds plus’ combines the above with cautious expansion of investment, including in PDMs, while building local management. Current 10% ‘ceiling’ might be lifted to 20%. Real returns of 3-4% attainable. Changes to Articles 14 & 15 required.

Strong move into Equities

A strong move into a foreign stock markets suggests a rapid move from the current 0% to 25% or 40% in equities. Returns could be 4% or more, but there is a real possibility of losses. Changes to Articles 14, 15 & 20 (if using securities) required.

6. Institutional Implications

- All reforms require amendments to Articles 14 and 15 of the Act. A move into securities would require changing Article 20.
- This report, supports the 'ESI' benchmark, but suggests changing the name to ‘Nominal Sustainable Income’ (NSI), so that the benchmark is not confused with what is estimated as sustainable.
- If investment is made through a wider range of currencies, the discount rate (‘i’) might be revised, perhaps on a trade weighted basis.
- Building the capacity of the BPA team would best parallel the gradual expansion of investment options.
- ‘Diversification’ of investment instruments should not be confused with ‘diversification’ of managers. The former is prudent, the latter could increase waste and undermine accountability.

Part B:

Development Strategy in Timor Leste

7. Development Strategies

The private ‘market economy’ approach

The market economy approach has particular sectoral implications which differ from the emphases under ‘developmental state’ and ‘human development’ strategies.

The ‘developmental state’

A ‘developmental state’ approach, used in East Asia, stresses the necessary coordination between the state and public and private companies, to *improve* a country’s ‘comparative advantage’.

Human development emphasis

The ‘human development’ approach places great emphasis on large scale education, participation and health.

Private ‘market economy’ strategies

- Open markets, comparative advantage, 'broad based growth', 'pro poor growth', privatisations, 'user pays', 'trickle down' effect
- Minimal free services, ‘safety nets’, privileged exports, ‘enabling environment’ for private sector, 'stimulus package' subsidies
- **Examples**: Western model (selectively applied), favoured by corporations - has never 'developed' any country
- **Challenges: w**eak strategic plan, excludes the poor, failures of basic services

The ‘developmental state’

- State-led planning, ‘competitive (c.f. comparative) advantage’, institution building, 'autonomy' of state from private investors
- Coordination of human resources and industry, state investment, capitalist or socialist versions
- 'Circular and cumulative causation', develop linkages, industrial cluster development (UNCTAD)
- **Examples:** East Asia (Japan, South Korea, China, Singapore), Venezuela, Mauritius
- **Challenges:** Needs political will plus popular support, needs strong human resources

Human development emphasis

- Focus on core 'capabilities': participation, education, health, social equality - capabilities as goals, not just means to economic goals
- Wider view of development - strong push to build human resources, public health /education systems, value of customary land
- **Examples:** Japan, Sweden, Kerala, Cuba, Venezuela, Singapore
- **Challenges:** Coordination and mobilisation of human resources

Table 7.1 Development Strategies			
	Private Market Economy	**Developmental State**	**Human Development**
Ideas, strategies, emphases	Open markets, broad based growth, comparative advantage	State-led planning, ‘competitive advantage’, institution building	Participation, human capabilities, human resources
Sectoral implications (education, health, infrastructure, economy)	Minimal free services, ‘safety net’, export infrastructure, privatisation, ‘enabling environment’	Coordination of human resources and industry, state investment, capitalist or socialist versions	Strong push in education and health, participation, equality
International experience	Western model (selectively applied), favoured by corporations	East Asia (Japan, South Korea, China, Singapore), Venezuela	Japan, Kerala, Cuba, Venezuela, Singapore
Challenges	Weak strategic plan, excludes the poor	Political will, human resources and popular support needed	Coordination, mobilisation of human resources

8. Strategies in Timor Leste

The National Development Plan, 2002

- The NDP has strong economic liberal elements, but is moderated by some developmental state influences in planning and natural resource management, and by some human development emphases in participation and a more equitable approach to education, women and rural development.

Fretilin-led heterodoxy, 2001-2006

- The Fretilin led government used some strong economic liberal language but pursued heterodox policies, such as an independent agricultural policy, a cautious and autonomous fiscal policy, while developing education, health and school feeding programs as ‘rights-based’ free services. This was a human development approach, at odds with the ethos of ‘market economy’ programs.

The AMP and big money, 2007-2010

- The AMP coalition had access to larger budgets and spent money more freely, in line with ‘market economy’ ideas. A ‘Strategic Development Plan’ presented in 2010 had some more heterodox ideas, such as ambitious educational goals, but AMP practice remains orthodox. The proportion of the state budget dedicated to both education and health has fallen. Leasing large tracts of land to agri-business companies and radical tax cuts are further signs of economic liberal practice.

- Both governments have demonstrated strong national will over petroleum development. This shows the capacity to support development plans, but strategic capacity is undermined by ‘market economy’ ideas.

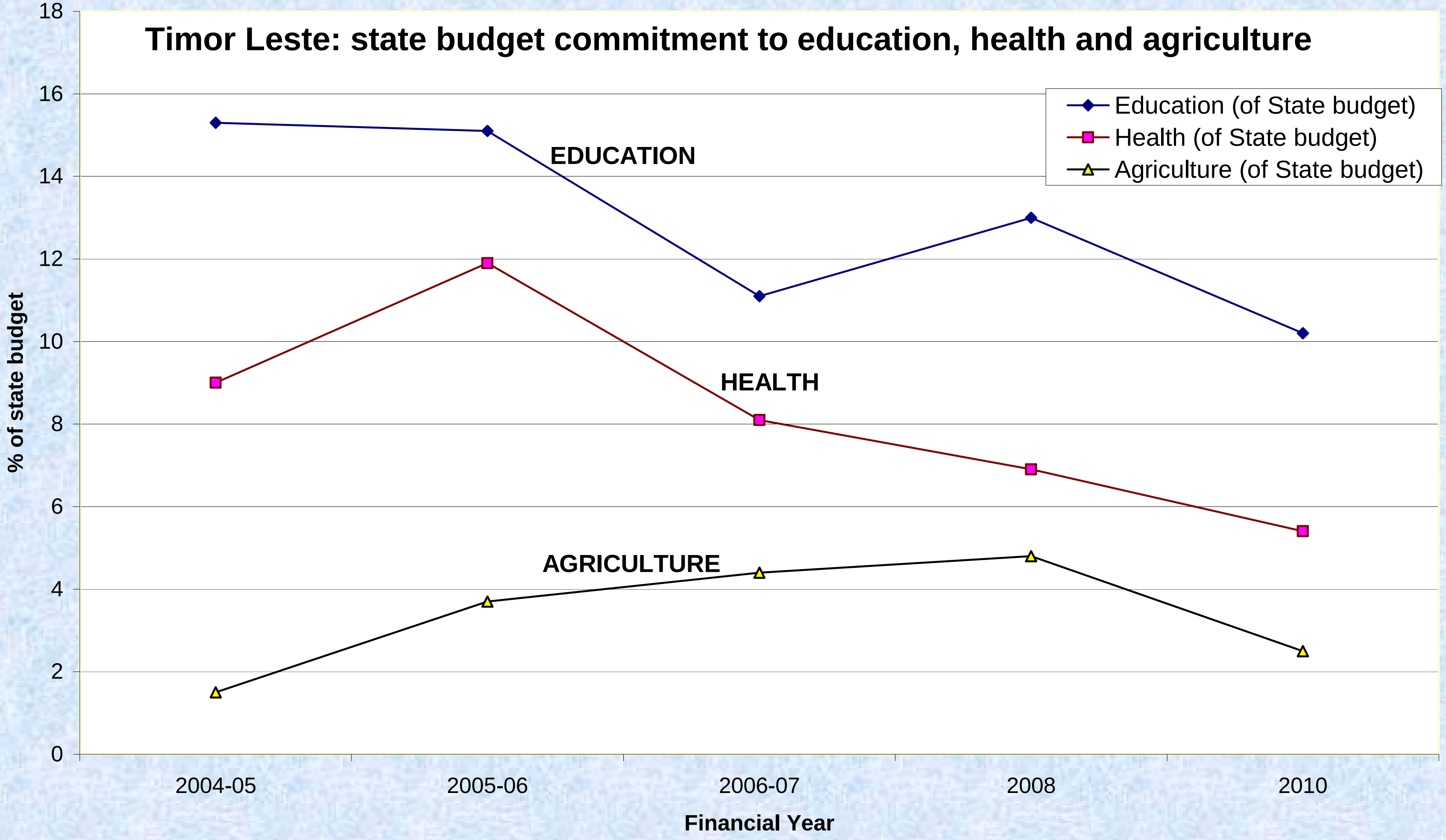
9. Strategy, debate and the neglected sectors

Strategy and debate

- Wide ranging debates on development strategy in Timor Leste are important. It seems useful to consider a centre, perhaps at the National University, to promote wider discussion and debate amongst young Timorese on development finance and development strategy.

Neglected sectors: agriculture, education, health

- Recent declining budget commitments to agriculture, education and health deserve special attention.



Note: (i) declining commitment to education and health, (ii) undervaluation of agricultural production contributes to under-investment

Debating development strategy

- a necessary form of participation
- where can such debate occur?
  - UNTIL, NGOs, public fora, Parliament, the districts?
- will debate / development options be considered?

thank you!