Svein Gjedrem: From oil and gas to financial assets – Norway's Government Pension Fund – Global

Speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at the conference "Commodities, the Economy and Money" in Calgary, Canada, 20 June 2008.

* * *

Introduction

Good morning and thank you for the invitation to this highly topical conference. I have been asked to talk about the "objectives and experience of the Norwegian oil fund". In doing so, I will try to explain the set-up and purpose of the Fund and draw some preliminary conclusions about the outcome so far.

Since Norway became an oil nation some 40 years ago, the petroleum sector has grown to become an important part of our economy. Today, petroleum accounts for approximately 25 per cent of Norway's gross domestic product (GDP).

And even though the production of oil is declining after peaking around the turn of the millennium, total petroleum production will remain high for many years to come.

The economic challenges posed by petroleum extraction were widely recognised early on. As early as in 1974, the Norwegian parliament discussed these challenges in depth, and in the early 1980s, the idea of a fund that would stabilise petroleum revenue spending was launched. Due to domestic economic turmoil and financial crisis in the late 1980s and early 1990s, it took time before the idea of a fund was turned into actual savings.

Why a Pension Fund?

The Government Petroleum Fund was formally established in 1990. In 2006, the name was changed to the Government Pension Fund – Global. In spite of the name change, the Fund is more similar to an endowment than to a pension fund.

Since the first transfer of some USD 400 million was made in 1996, the Fund has grown rapidly in size. Its assets are currently valued at around USD 400 billion. One third of the portfolio, about USD 130 billion is invested here in North America. The Fund is expected to grow rapidly in coming years, and may double in 5-10 years.

The Fund was established as a tool to support prudent management of Norway's petroleum wealth. One purpose is to shield the non-oil economy from price fluctuations (see Chart 3). The Fund is also a long-term savings instrument. It will help to cope with future financial commitments linked to an ageing population.

Accumulation of capital in the Fund reflects the depletion of a non-renewable resource, which is exchanged for financial assets through the Fund's investments. By setting up the Fund, it became possible to establish a path for production of oil and gas that is independent of the profile for petroleum revenue spending.

Furthermore, to effectively shield the non-oil economy, and to make sure that private sector investment decisions could be made independently of the public sector's saving of petroleum wealth, the Fund is only invested abroad. This also enhances the expected return on government wealth and reduces the risk.

The alternative to a fund would have been to directly regulate production by putting a conservative upper limit on annual extraction. This was attempted in the 1970s and -80s. At that time, we had a production ceiling of 90 million standard cubic metres per year. This approach was abandoned in the 1980s. Today, the government steers exploration activities and awards production licenses, but has no explicit production target. Since the mid-1990s, total petroleum production has been around 250 million standard cubic metres per year.

The Fund mechanism

The Fund is by law fully integrated with the government budget, and the same priorities are imposed on spending from the Fund as on any other government spending. This means that the entire petroleum revenues are transferred to the Fund. An amount equal to the non-oil budget deficit is then transferred to the fiscal budget. The mechanism ensures that the accumulation of capital in the Fund is equal to government net financial savings. There is no corresponding increase in liabilities.

Furthermore, legislation prohibits use of Fund money for purposes not prioritised in the regular budget processes. There is no hidden use of oil money, or any use for special purposes. The Fund is strictly and effectively “out of bounds” to special interests.

In 2001, the Norwegian parliament approved new fiscal policy guidelines stipulating that the annual transfer from the Fund to the fiscal budget – that is annual spending of oil money – should correspond to the expected real return on the Fund. The expected real return is estimated at 4 per cent. The point of reference for the spending rule is a normal cyclical situation. In the event of particularly high capacity utilisation, spending should be lower than 4 per cent, whereas in a cyclical downturn, somewhat higher spending may be appropriate.

The intention is for this wealth to be transferred to future generations, and that each generation should only spend the returns. The rule gives weight to long-term considerations when addressing current economic policy challenges. The rule also helps stabilise exchange rate expectations.

The fiscal rule has the advantage of having intuitive appeal, and it is easy to check whether it is being followed over the business cycle.

In line with the rule, the transfer from the Fund was higher than the expected real return of 4 per cent in the cyclical downturn in 2003 and the following two years. Since 2006, however, the transfer has been lower. It should also be noted that the target for the rule is the cyclically adjusted transfer, shown by the solid line in Chart 6. Automatic stabilisers are allowed to work, thereby reducing actual transfers during upturns and increasing them during downturns, as illustrated by the broken line in Chart 6.

Governance structure and management model

Now, let me turn to the Fund management model. The governance structure is based on a clear division of responsibilities between the political authorities and the operational management.

- The Ministry of Finance is the owner of the Fund. The Ministry defines the mandate and monitors and evaluates performance.
- The management of the Fund is delegated to Norges Bank. The Bank’s task is to implement the investment strategy and exercise ownership rights. Norges Bank also provides professional advice to the Ministry on investment strategies.

The Fund’s investment strategy is to maximise financial return with moderate risk. The long-term strategic allocation is defined in terms of a benchmark portfolio, which consists of equities and fixed income instruments. Equities account for 60 per cent of the Fund's strategic benchmark portfolio. The size of the Fund implies that it currently owns about 1 per cent of listed European equities and ½ per cent of listed equities on a global basis. Fixed income instruments account for 40 per cent.

Furthermore, the Ministry has recently decided that the Fund should prepare the ground for investing in real estate at 5 per cent of the strategic benchmark portfolio. In time, this will reduce the fixed income share to 35 per cent.

Norges Bank has built an organisation with emphasis on investment returns and based on three fundamental principles: Accountability, transparency and professional standards.

Norges Bank manages parts of the funds internally, while parts are managed by external managers appointed by the Bank on a commercial basis. Active management has become an important part of our investment operations. We believe that the search for excess return has had a strong disciplinary effect on the organisation.

Transparency and disclosure of information is a key feature of the Fund. All investment principles and guidelines as well as strategic advice and second opinion reports are made public. We publish quarterly reports on Fund performance, which are presented at press conferences. The Fund's annual report discloses a list of every single investment held at the end of the year, and also provides an overview of corporate governance work, including voting at general meetings.

Initially, transparency was aimed at building confidence among Norwegians, but we have also seen that our policy of transparency is highly appreciated internationally.

The challenges for the Norwegian economy

The risk of "Dutch disease"[1] is often cited when discussing the impact of natural resource windfalls.[2] Dutch disease occurs when the basis for internationally exposed industries is eroded and fluctuations in economic activity are amplified.

In our case, we can say "so far so good". The economy has been fairly stable and oil price fluctuations have only had a moderate impact on our currency.

Furthermore, while it is difficult to know how the economy would have developed without oil, we have a sort of "control group". The other Nordic countries – Denmark, Finland and Sweden – are comparable in size and structures, but are mainly non-oil economies.[3] Three indicators may be relevant in this context.

First, there is no evidence that our productivity growth has been eroded. In fact, Norway has generally managed to sustain high productivity growth compared with most other advanced countries.

Second, there is no evidence that labour force participation has been impaired. In fact, labour force participation is now high, after having lagged behind our neighbouring countries up to the mid-1980s.

A third indicator is welfare spending. Here, there is evidence that developments have been less favourable. Norway has seen a sharp increase in sickness absence and a steadily higher share of the working-age population is on disability benefit or rehabilitation schemes. Over the past decade, Norway has underperformed on this score compared with the other

---

[1] The expression "Dutch disease" originates from the Netherlands, where the government rapidly spent large revenues from extraction of gas in the 1960s.

[2] The economic literature includes many studies that look at the relationship between income from natural resources and economic growth, see for example Jeffrey D. Sachs and Andrew M. Warner, "The curse of Natural Resources", European Economic Review 45 (2001) and Thorvaldur Gylfason, "Natural Resources and Economic Growth: From Dependence to Diversification", Discussion paper No. 4804, CEPR.

[3] Denmark has also been producing oil and gas since the early 1970s, but on a smaller scale than Norway. The impact on the Danish economy has therefore been more limited.

Nordic countries. The growing number of people outside the labour force and on benefits is increasingly becoming the Achilles' heel of the Norwegian economy.

On balance though, the picture is fairly positive: We have managed to keep macroeconomic developments on a steady course, we have avoided dramatic changes in industry structure, and we use our resources fairly efficiently. It is, however, too early to draw definite conclusions. We probably have to wait another generation or two to see the long-term impact of this huge windfall.

The debate on sovereign wealth funds

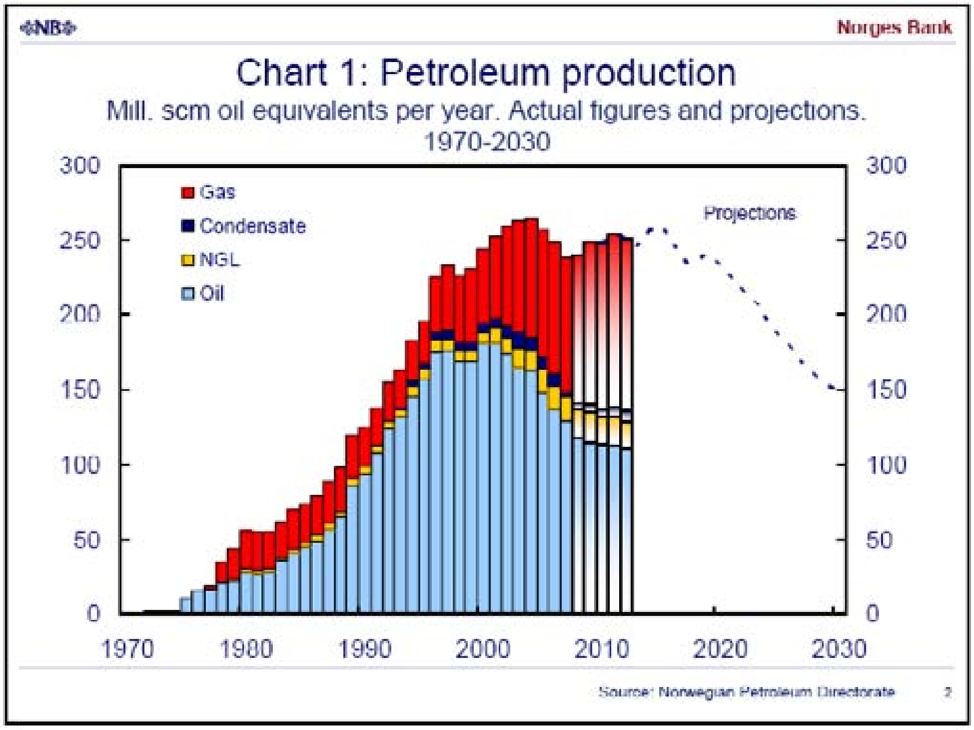
Let me wind up with a few words on the sovereign wealth funds debate.

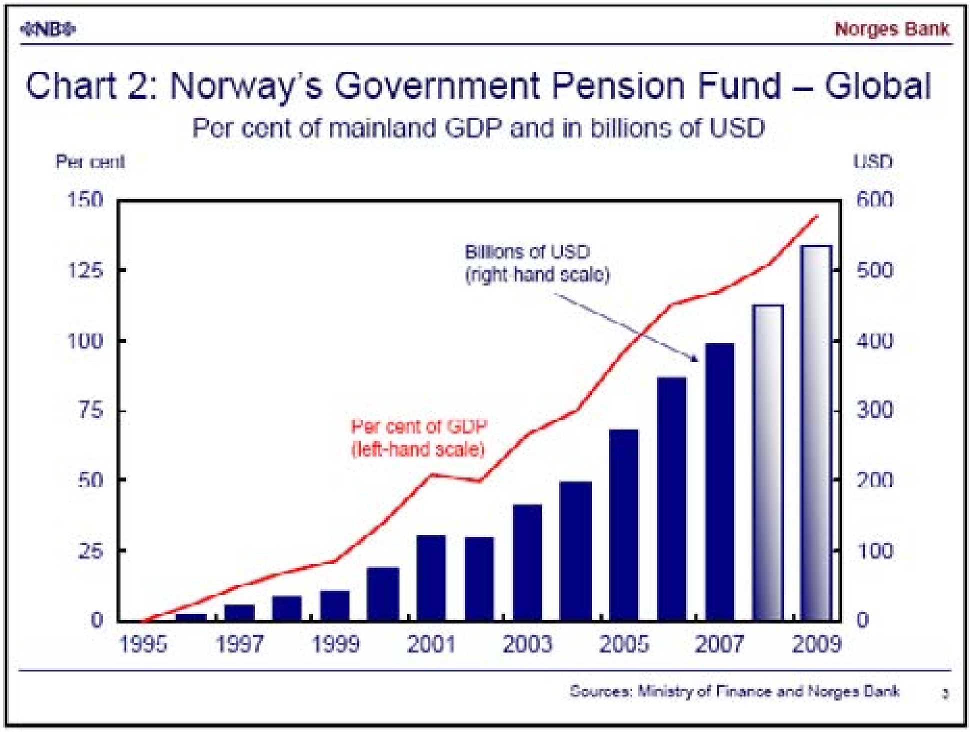
Typical features of many sovereign wealth funds are long investment horizons, no leverage and no claims for the imminent withdrawal of funds. This differentiates such funds from for instance the rising number of leveraged funds and investors with short time horizons. Hence, sovereign wealth funds have a strong risk-bearing capacity and an ability to accommodate short-term volatility. Sovereign wealth funds may reduce volatility in asset prices and increase efficiency. Again, transparency and disclosure of information is an important tool in building confidence. This runs both ways, of course.

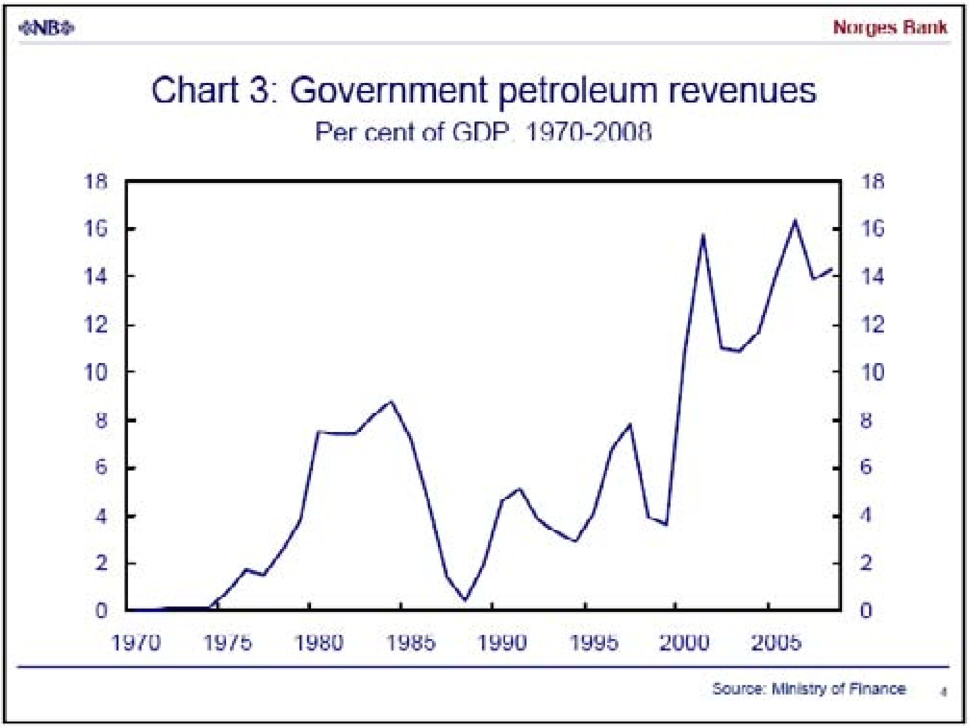
It should also be noted that the separation of spending of petroleum revenues from the current revenue stream through a fund mechanism allows oil producers to extract petroleum at a higher rate than would be appropriate if all the proceeds were to be redeployed in the domestic economy. Hence, the petroleum funds do not just offer an attractive way of recycling oil producers' revenues in international financial markets, they can also have an indirect stabilising effect on the oil market.

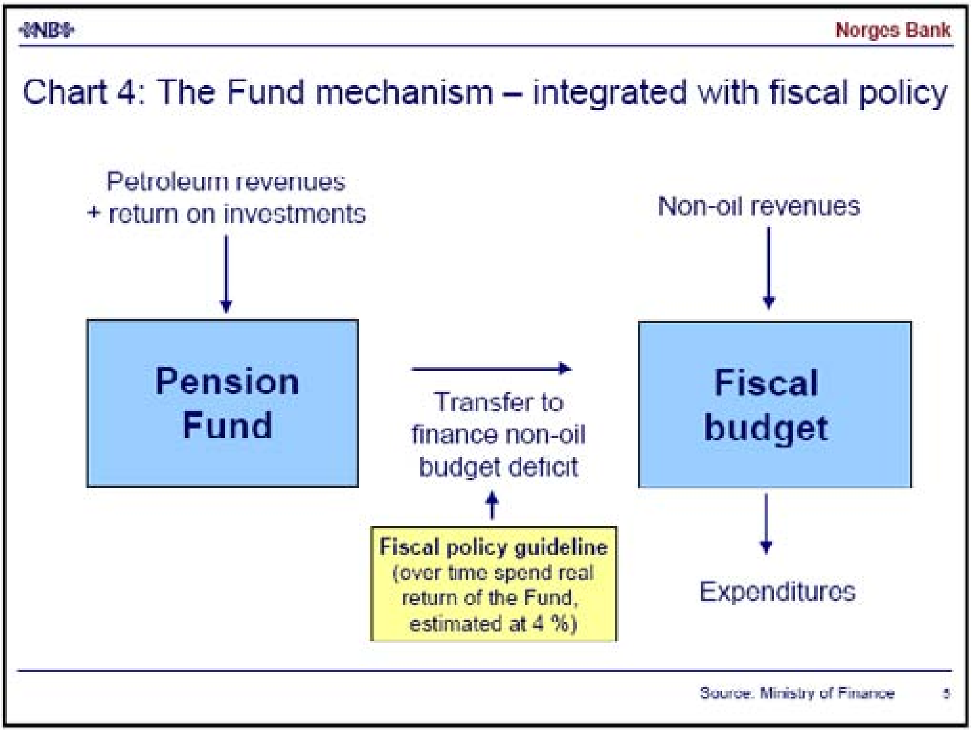
In my view, sound management of oil-producing countries' petroleum wealth is in everyone's interest.

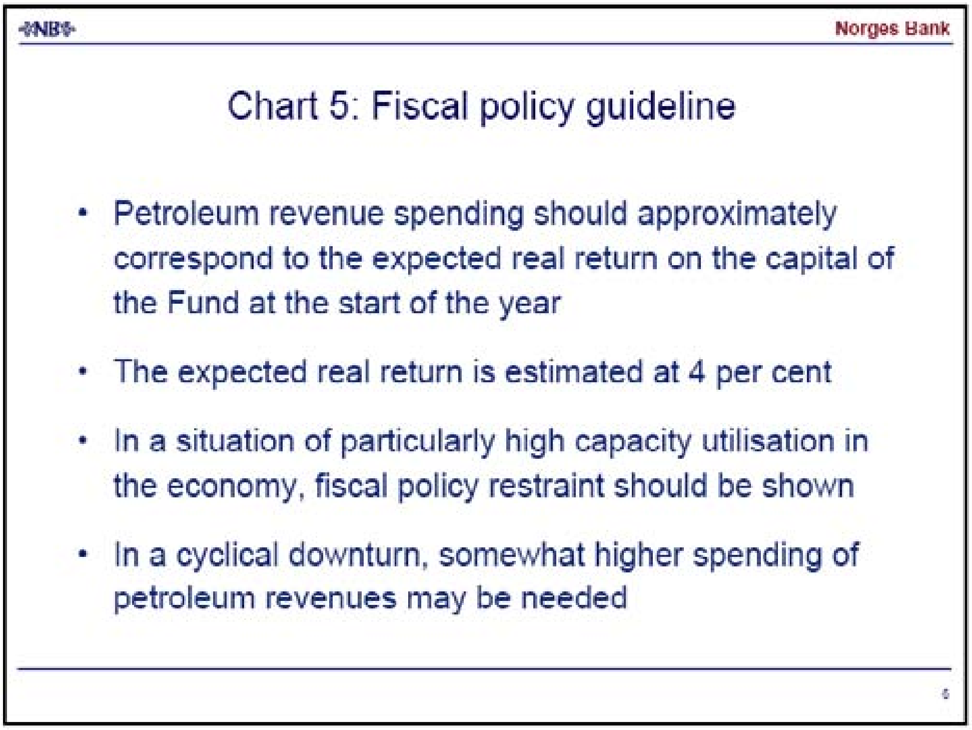
Thank you for your attention.

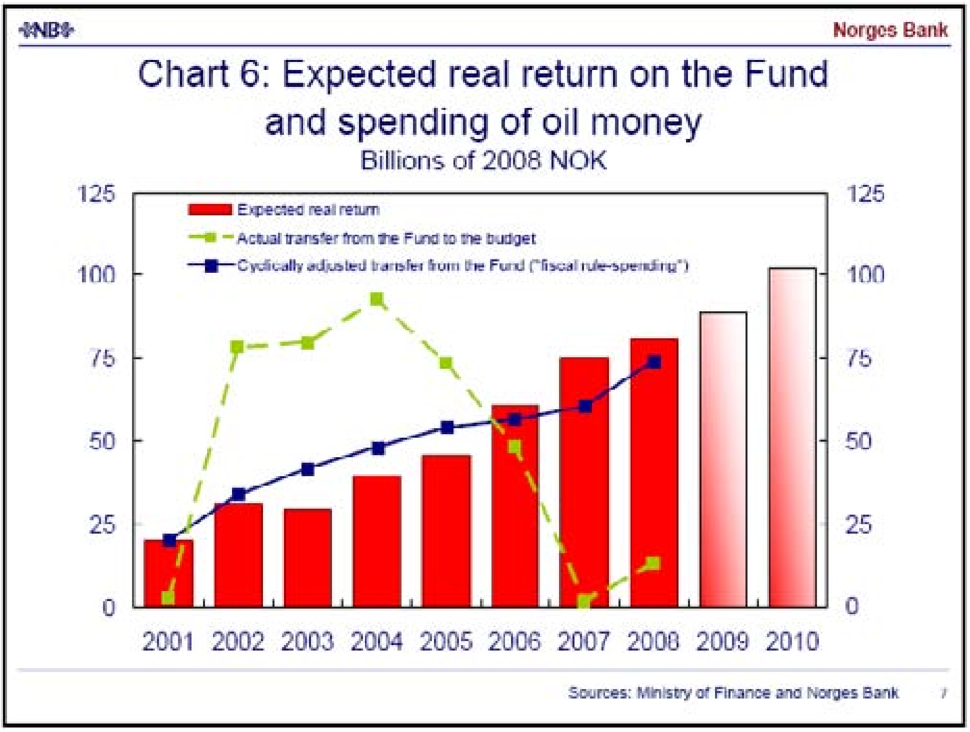


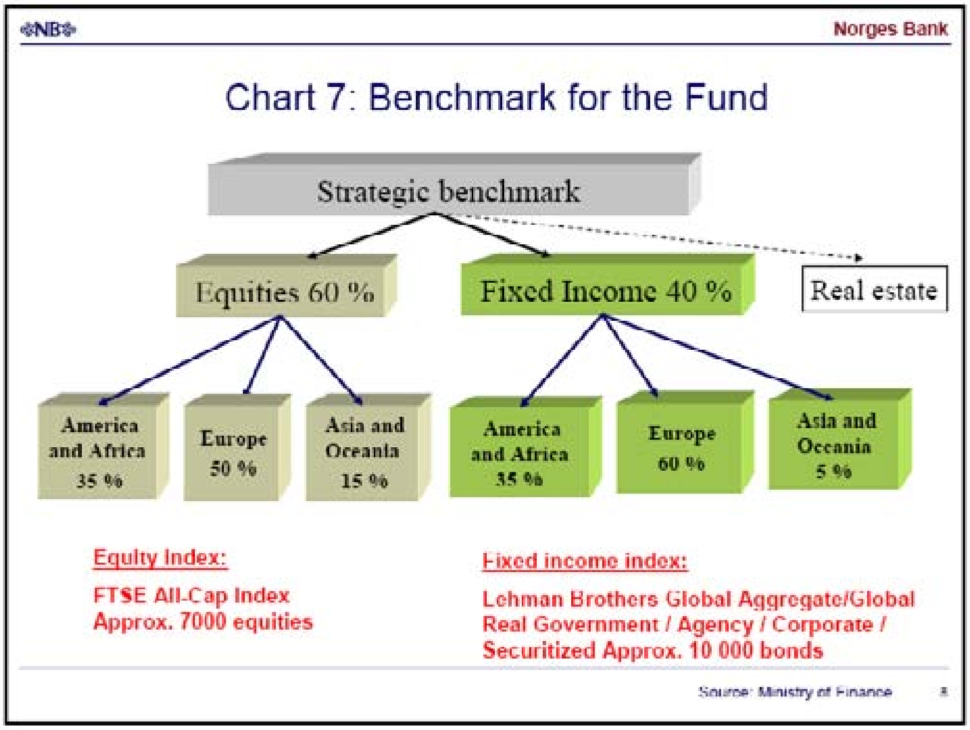

NB
Norges Bank
Chart 2: Norway's Government Pension Fund – Global
Per cent of mainland GDP and in billions of USD
Per cent
USD
Billions of USD
(right-hand scale)
Per cent of GDP
(left-hand scale)
150
125
100
75
50
25
0
600
500
400
300
200
100
0
1995
1997
1999
2001
2003
2005
2007
2009
Sources: Ministry of Finance and Norges Bank

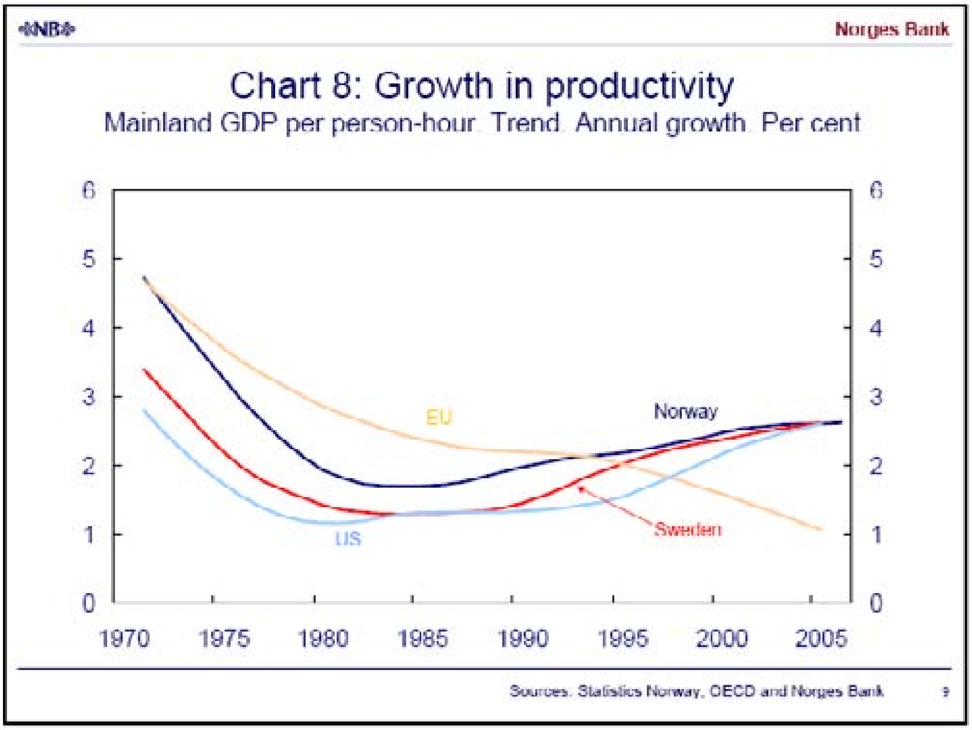

NB
Norges Bank
Chart 3: Government petroleum revenues
Per cent of GDP. 1970-2008
18
16
14
12
10
8
6
4
2
0
1970
1975
1980
1985
1990
1995
2000
2005
Source: Ministry of Finance


NB
Norges Bank
Chart 4: The Fund mechanism – integrated with fiscal policy
Petroleum revenues
+ return on investments
Non-oil revenues
Pension Fund
Transfer to finance non-oil budget deficit
Fiscal budget
Fiscal policy guideline
(over time spend real return of the Fund, estimated at 4 %)
Expenditures
Source: Ministry of Finance
5

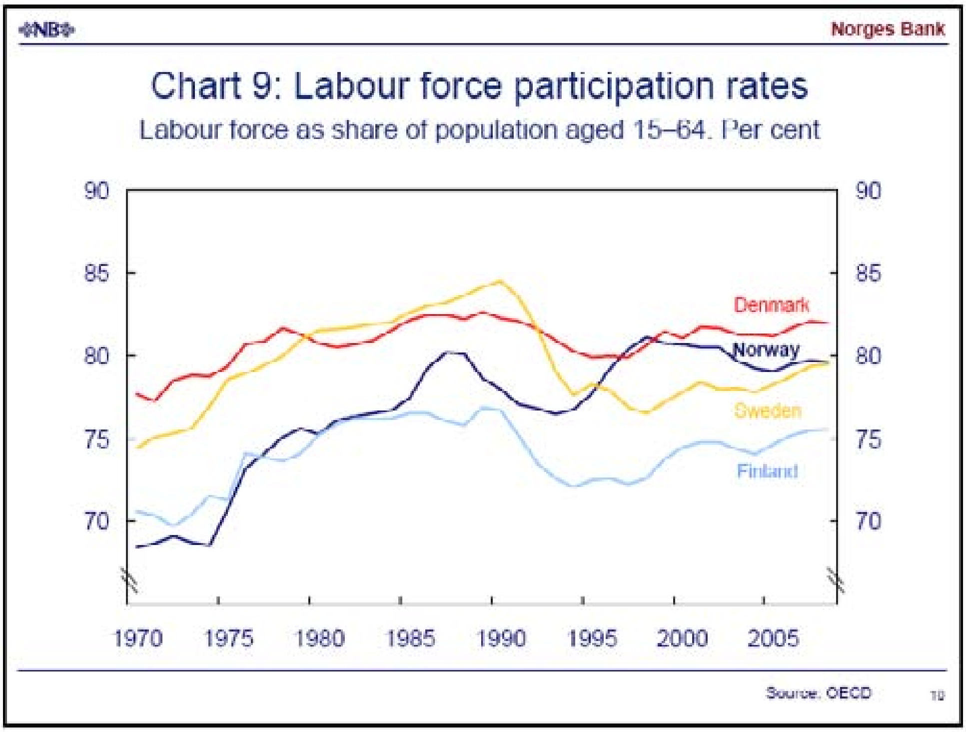

NB
Norges Bank
Chart 5: Fiscal policy guideline
• Petroleum revenue spending should approximately correspond to the expected real return on the capital of the Fund at the start of the year
• The expected real return is estimated at 4 per cent
• In a situation of particularly high capacity utilisation in the economy, fiscal policy restraint should be shown
• In a cyclical downturn, somewhat higher spending of petroleum revenues may be needed
6


NB
Norges Bank
Chart 6: Expected real return on the Fund and spending of oil money
Billions of 2008 NOK
Expected real return
Actual transfer from the Fund to the budget
Cyclically adjusted transfer from the Fund ("fiscal rule-spending")
125
100
75
50
25
0
2001 2002 2003 2004 2005 2006 2007 2008 2009 2010
Sources: Ministry of Finance and Norges Bank
7

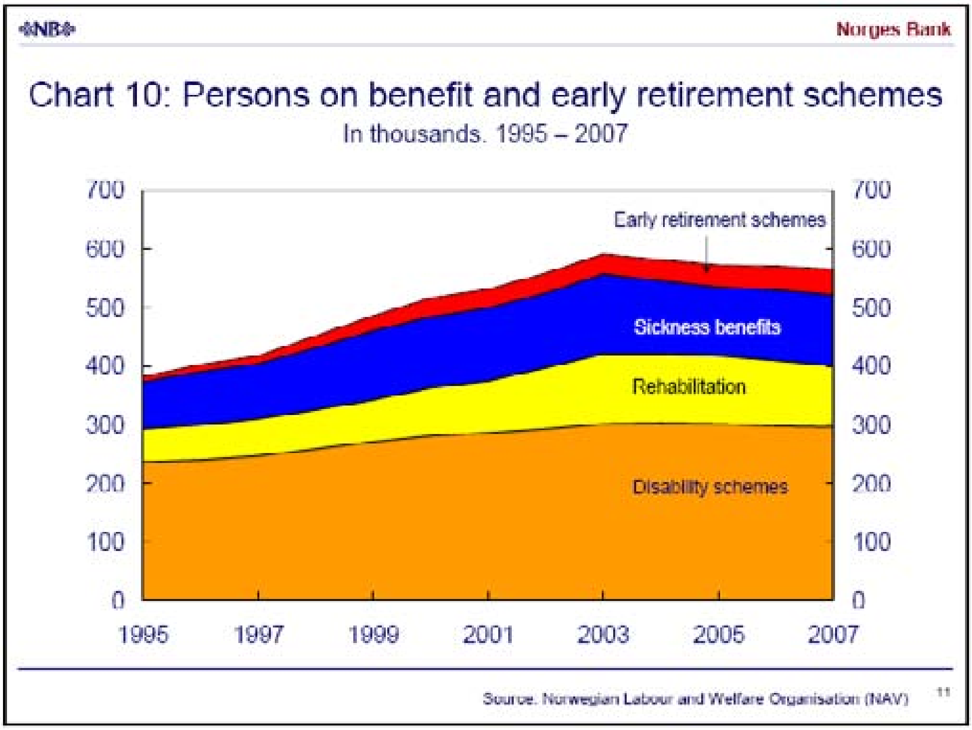

NB
Norges Bank
Chart 7: Benchmark for the Fund
Strategic benchmark
Equities 60 %
Fixed Income 40 %
Real estate
America and Africa 35 %
Europe 50 %
Asia and Oceania 15 %
America and Africa 35 %
Europe 60 %
Asia and Oceania 5 %
Equity Index:
FTSE All-Cap Index
Approx. 7000 equities
Fixed income index:
Lehman Brothers Global Aggregate/Global Real Government / Agency / Corporate / Securitized Approx. 10 000 bonds
Source: Ministry of Finance
8



Norges Bank
Chart 8: Growth in productivity
Mainland GDP per person-hour. Trend. Annual growth. Per cent
6
5
4
3
2
1
0
1970
1975
1980
1985
1990
1995
2000
2005
EU
Norway
US
Sweden
Sources: Statistics Norway, OECD and Norges Bank
9



Norges Bank
Chart 9: Labour force participation rates
Labour force as share of population aged 15–64. Per cent
90
85
80
75
70
1970
1975
1980
1985
1990
1995
2000
2005
Denmark
Norway
Sweden
Finland
Source: OECD
10


NB
Norges Bank
Chart 10: Persons on benefit and early retirement schemes
In thousands. 1995 – 2007
Early retirement schemes
Sickness benefits
Rehabilitation
Disability schemes
700
600
500
400
300
200
100
0
1995
1997
1999
2001
2003
2005
2007
Source: Norwegian Labour and Welfare Organisation (NAV)
11