Svein Gjedrem: Investing for the long run

Dinner speech by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at The Norwegian Government Pension Fund's Investment Strategy Summit, Oslo, 3 June 2009.

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Minister,

Ladies and gentlemen,

We are gathered here for a conference – and a dinner – centred on investing for the long run. And indeed, it is my expectation that the Government Pension Fund – Global will endure through good times and bad times in the markets to provide a permanent revenue stream for our children and grandchildren.

I would like to thank all the participants for the good advice and interesting analyses you have presented here today. It has really been inspiring to attend, and to listen to your presentations and discussions.

The oil age in Norway has spanned some 40 years, and it appears that it will continue for years ahead.

The idea of a fund arose in the early 1980s. Up to 1995, all government revenues were used for investment in the petroleum sector and to cover budget deficits during the recession around 1990.

The formal structure of the Fund was actually decided on in 1990 in the midst of a banking and currency crisis, with meagre growth and high unemployment. I have every reason to believe that the people that prepared the proposal did not think at the time that the savings in the Fund would prove to be of any significance.

By setting up the Fund – with investment abroad – it became possible for Norway to establish a path for the production of oil and gas that is independent of the profile for petroleum revenue spending. The alternative to a fund would have been to regulate the extraction path by putting a conservative upper limit on annual extraction.

The Fund serves as a buffer between wide swings in petroleum revenues and domestic spending. The decisions on annual revenue spending can be made independently of the size of the revenues. As a result, swings in petroleum revenues do not have an automatic impact on the Norwegian economy. The existence of the Fund contributes to stabilising the NOK exchange rate, and countercyclical economic policies are more effective for a country with net foreign assets.

The virtues of the fund structure are many. The authorities have established a transparent system for managing government petroleum income as all oil revenues are transferred directly into the Fund. The Norwegian parliament must adopt a resolution on any use of the return or the capital of the Fund. Oil revenues are not earmarked. There is no hidden use of revenues, or any use for special purposes. The Fund is strictly and effectively "out of bounds" to special interests. It is important that this remains a feature in the future.

We now have close to fifteen years of a rapidly expanding Fund behind us, and it is becoming more likely that the fund will be a very long-term savings plan. The plan is underpinned by a political commitment to spend only the expected real return of four per cent over the business cycle. Nevertheless, we should not underestimate the risk that extraordinary economic circumstances could turn a surplus into a deficit.

The 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. Sound returns on these investments will help us cope with future financial commitments linked to an ageing population.

But at the same time as the wave of an ageing population flows towards us with its demand for public services and increased consumption, we also should ask if investments in Norway could be an alternative to those we make in international financial markets. And clearly, a good argument could be made for investing more in schools, universities and research to develop our human capital. But that should be possible in any case, given the increased spending the fiscal rule already allows for.

It could also be argued that we should invest more in our domestic infrastructure, for example roads and highways. This may be important for regional reasons. But on the margin, these investments are probably not adding very much to our economic growth. To illustrate this point, the net present value of road projects in the new 10-year national investment plan is estimated at some minus NOK 20 billion after positive effects on road safety and the environment have been taken into account.[1]

Among other important tasks in coming years and decades, the government would need return from financial assets to provide for future pensioners. We can probably expect that productivity and real wages will continue to grow in parallel, and future pensioners would most likely want to take part in that welfare gain. This may imply that government expenditures will increase more than the overall growth in the economy, as the number of pensioners is growing fast and the demand for healthcare also will be higher. Although real wages increase, it will not be easy to raise the tax level. Thus, the government will need return from financial assets to finance the increased expenditure for pensioners.

International capital markets have played a crucial role in allowing us to follow the strategy for extraction of petroleum. We drew heavily on borrowing opportunities abroad when the petroleum industry was being built up. We did the same in order to expand welfare schemes and to finance the countercyclical policy of the mid-1970s and the early 1990s. Over the last decade and a half, international capital markets have enabled us to convert national oil and gas resources into equities and bonds abroad in the Fund.

The implementation of our investment strategy is dependent on free capital movements. I would like to remind the audience that only some twenty five to thirty years ago we had very rigorous capital restrictions ourselves. For instance, Norwegians could only purchase foreign equities through a fixed pool established in the 1960s (by using the so-called “security dollar” market), and foreigners’ investments in Norwegian equities were strictly regulated and actually limited to NOK 50 000 per person until 1979. That ceiling was raised to NOK 1 million in 1979.

Experiences over the past year may cast doubt on the effectiveness and benefits of international capital markets. Nevertheless, history has seen a number of deep financial crises, and it is my belief that market conditions will also return to normal this time. I am confident that private entrepreneurship and public limited companies will continue to exist as the primary organisational bodies for commercial activities. Owners and investors will also be needed in the years to come. But capitalism will have to adapt. After all, the willingness to trust the free play of market forces in finance has been seriously impaired.

International stock exchanges lost more of their value in 2008 than in any other single year in recent history. Absolute results, especially with regard to equities, were highly unusual. Many investors have suffered losses. As a result of this experience, required returns will be higher in the future. An investor such as the Government Pension Fund – Global will earn more in the long term because of wide fluctuations in equity values.

[1] National Transport Plan 2010–2019 (St.meld.nr.16 (2008-2009).

The Fund has a longer investment horizon than the vast majority of other market participants. The important question is therefore how sound today's investments will prove to be in the long term. The government now owns close to one per cent of the global business sector. This represents real value that will provide a return reflecting both global economic growth and the risk related to fluctuations in equity prices.

Another virtue of the Fund is the strict division of labour between the Norwegian government as owner and Norges Bank as the manager. The bank has been given a clear mandate which regulates our responsibilities as the operational manager of the Fund.

The Fund has important distinguishing characteristics which form the basis for the investment strategy. The most important are its size and long-term investment horizon. Our potential to achieve results as an investor lies in turning these factors to the Fund's benefit through active strategies, and our most important advantage is the possibility of implementing these strategies at low cost.

Our owner expects added value from active ownership. It is important that large institutional investors such as Norges Bank exercise their rights as minority shareholders. In our dealings with companies, our legitimacy and influence depend on us being seen as a long-term investor pursuing financial interests.

It is clear to me that the quality of the investment management organisation can only be ensured by pursuing excellence in all parts of the investment activities. To build an organisation which aims to be average will only assure mediocrity.

The financial crisis revealed that many institutions based their strategies on short-term funding. When credit was no longer available, many business models collapsed. Heavy losses were passed on to owners and investors.

The situation for savings in the Fund is different. We have had to record losses on equity investments and active credit investments. However, the Fund has no traditional liability side and liquidity risk is low. The growing risks in the market did not force us to make changes that would have resulted in huge realised losses for our owners.

The final results of our strategies through the troubled waters of the financial crisis cannot be deduced from the quarterly results at the peak of the crisis. Actually, the Fund has spent the last few quarters increasing its ownership in companies worldwide. As for credit, values are not lost as long as borrowers fulfil their obligations. The Fund is prepared to retain ownership of its illiquid investments until they mature in a few years time. Moreover, unless the economic outlook goes from bad to considerably worse, the Fund will record a substantial excess return in years ahead from holding on to assets that the market has priced down due to a collapse in liquidity and fear. In fact, as the global economy seems to be stabilising, this effect is already evident.

Let me conclude by underlining the topic of this conference: "Investing for the long run". The Fund is a long-term savings plan and capable of riding out large swings in the markets. This is the very foundation of the investment strategy. Our ability to adhere to this strategy in a critical phase – even if this should last for some time – is crucial if the Fund is to deliver the returns we expect in the longer term.

Thank you for your attention.