Ewart S Williams: Understanding the Heritage and Stabilisation Fund

Address by Mr Ewart S Williams, Governor of the Central Bank of Trinidad and Tobago, at the Rotary Club of Port of Spain Central, Port-of-Spain, 8 May 2008.

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Thanks for inviting me …… it is nice to be invited to talk about something other than **inflation** and it is certainly a delight to talk about, the Heritage and Stabilisation Fund, because it is a good story, **a very important economic policy instrument with tremendous upside potential**. In my view, it is an instrument that could go a long way to helping Trinidad and Tobago achieve its Vision 2020.

There is no doubt that **our country is in the midst of a major economic boom**, driven by the energy sector.

Our macro-economic performance since the start of the decade has been impressive indeed. To quote a few of the statistics:

- **Real GDP** growth has averaged close to 9 percent since 2002;
- **per capita income** has more than doubled from US$7,000 to US$16,000;
- **unemployment** has been halved from 10.4 percent in 2002 to under 5 percent;
- **the public debt ratio** has also been halved to about 30 percent of GDP while;
- **our net international reserve position** has risen from US$1.7 billion to US$7 billion.

Of course, the current economic success has not been without its downside. Specifically, the economic boom has been accompanied by a **pick up in inflation** to close to double digits; **real estate prices** continue to soar, notwithstanding concerted efforts by the Government to increase the supply of houses; and rapid growth has brought to the forefront **serious capacity constraints** …. in the **labour market**, in **the public utilities**, and in our **road network**, to cite a few. At the same time, with rising incomes and buoyant domestic demand, lagging agricultural production has shown the consequences of unbalanced development.

But many of you would remember that we passed this way before.

You would, no doubt, recall the first oil shock in the late 1970's and early 1980's when there was a significant increase in oil prices and government revenues.

Some of this windfall went to finance the **start-up of the petrochemical platform**, from which we are now benefiting. However, the economic boom unleashed enormous demand pressures, both private and public, such that when oil prices collapsed, the economy went into recession, and we were forced to tighten our belts in a disorderly and painful downward adjustment.

Having learnt our lesson, when oil prices started to rise in the late 1990's, the Government established an **Interim Revenue Stabilization Fund.** Annual contributions were made to the Fund since 2000, but **it became** a **formal legal entity**, only in March 2007, with Parliament's approval of the **Heritage and Stabilization Fund**.

What is this Heritage and Stabilization Fund?

It is a Fund – where proceeds from energy sector revenues are set aside – firstly, to be available if there is a sudden temporary decline in oil prices; and secondly, to generate savings for future generations.

The rationale for **setting aside funds for a rainy day is rather obvious.** Notwithstanding the surge in oil prices since the turn of the current decade, oil and gas prices are inherently volatile and even the most optimistic projections suggest that, at some time, **oil prices will revert to a more normal long term equilibrium level**. Given our economy's heavy dependence on oil and gas, a sharp fall in prices will affect government revenue and could require a drastic cutback in government spending. By putting aside some resources for stabilization, the Government would have the ability to cushion the impact on its spending and consequently on the level of economic activity. (Recall the cut in civil servants' salaries in the 1980's.)

The rationale for setting up a savings fund is a bit more complex and incorporates both economic and ethical considerations. It says that natural resources are an **exhaustible asset**, the benefits of which should be spread over generations. And therefore what a **savings fund** does is to transform the assets under the ground (in our case oil and gas) into a diversified portfolio of financial assets, which can be managed to provide an independent source of foreign exchange income. This income will be available to the budget when the oil and gas resources have dwindled or have completely run out.

Building up the Fund sufficiently and investing it wisely would allow us to **preserve the capital** (like keeping the oil in the ground) while living on the interest.

Future generations will thus be able to enjoy the benefits of oil and gas resources, even when the oil and gas resources are gone.

The flow of investment income from the Fund could go on for a very long time **if you have built up sufficient assets and if the country's fiscal position is sustainable over the long term**.

Many resource-rich countries – both large and small – have seized on the idea that Sovereign Wealth Funds are an important part of economic management.

The **HSF Act** approved by Parliament in March of last year, is therefore a most important piece of legislation.

In line with international best practices, the legislation provides for **clear deposit and withdrawal rules; a governance structure that seeks to incorporate checks and balances and provisions to ensure the highest level of transparency and accountability in the management of the country's money**.

Broadly speaking:

- **the deposit rule requires that** a minimum of 60 per cent of the excess between actual and budgeted energy revenues must be credited to the Fund, while;
- **the withdrawal rule** allows the Government to tap into the Fund to cover 60 per cent of any revenue shortfalls. There is a cap on the amount of the Fund that could be used for stabilization.

There are some **other significant provisions** in the law or in the principles underlying the Fund. Thus, for example:

- HSF deposits are to be invested abroad, with a medium to long term focus;
- In principle, the Fund should be invested in assets not directly related to oil and gas (so as to avoid contagion);
- The Fund cannot be used to **directly finance capital expenditure** or as collateral for government borrowing;
- The Act comes up for review every five years; and

- As I said before, the Fund should be characterized by the highest level of transparency of objectives and results, and clear accountability and professionalism in its management.

The legislation clearly outlines the roles for the major players – **Minister of Finance**, **the Board of the HSF**, **the Central Bank**, and the **Parliament**, which represents the people, as the ultimate authority.

The Minister of Finance is responsible for approving the deposits and withdrawal from the Fund (according to the formula).

The HSF Board decides on the investment objectives of the Fund and approves the Strategic Asset Allocation – which in effect is the **definition of the overall risk-return profile of the portfolio**. In the final analysis, the Board is answerable for the overall performance of the Fund but it delegates this function to **the Central Bank, which is given responsibility for the day to day management of the Fund**. To fulfill its function, the Bank will make extensive use of external fund managers which it will help to select and oversee. The Bank is also available to give technical advice to the Board as required.

The Parliament, as representative of the people **has the ultimate oversight role of the Fund**, exercised through review of the annual reports and the audited financial statements.

The **Norwegian Petroleum Fund** is recognized as the benchmark for transparency and disclosure of information. **The Norwegian Ministry of Finance reports to Parliament on all important matters relating to the Fund such as the size of petroleum revenues**; the outlook for fiscal sustainability, any planned changes in investment strategy and the Fund's performance, risks and costs.

Ladies and gentlemen, it is extremely important for the population to understand the purpose of the Fund and how it is expected to work. For example, it is particularly important to distinguish the management of the HSF from that of the country's official reserves.

As you know, the country's official reserves are managed by the Central Bank, and from time to time we are accused of being too conservative: too safe with your money. But that's the mandate. For all central banks one objective of reserve management is to avoid risk of any loss, to maintain the capital at all cost, even if you make low returns.

The HSF, however has a different rationale and consequently a different investment strategy or as it is called, a different **Strategic Asset Allocation.** Basically, the HSF resources are to be invested with an eye to maximizing returns, subject to an acceptable level of risk.

Thus, the strategic asset allocation (or the investment plan) of the HSF calls for some short term investments – US Treasuries (since liquidity is important to meet any drawdown to finance stabilization needs); some longer term US fixed income securities and US and other developed countries' equities.

Through the HSF, the country will be introduced to investing some of its resources in international equities for the first time. And why? **Because empirical evidence suggests that, over the long term, investments in stocks provide the highest rate of real and nominal returns**.

Evidence also shows, however, that investments in stocks experience the greatest volatility.

For example, if we had invested in the US equity market (in Grade A stocks) over the last 20 years we would have earned an average annual return of 11½ percent compared with an 8½ percent return we could have earned in US fixed income instruments.

However, the volatility of the equity portfolio would have greatly exceeded that of the fixed income portfolio. In fact, for two or three of the twenty-year period, the portfolio would have registered losses because, that's the nature of the equity market.

If you are in the market for the long haul, however, the evidence suggests that you will come out ahead and substantially so.

Because of the high stakes involved and because of the highly specialized nature of investing in equities, most sovereign funds outsource part of the management of their resources to specialized external managers. These external managers are given specific mandates, with specific targets or benchmarks and their fees are tied to returns in excess of the benchmark.

I should note that since the HSF Act has been approved, much has been achieved:

- As you may know, the **HSF Board** has been appointed.
- The Board has approved **the Strategic Asset Allocation.**
- The Central Bank is in the process of **selecting the External managers,** a process that we expect to complete in the next few months.
- The first **Audited Annual Report** of the HSF has been prepared and has been submitted to Parliament; the Central Bank has also prepared quarterly reports that are sent to the HSF Board.
- Pending the appointment of the external managers, the HSF Board has approved a transitional investment plan that's currently being implemented by the Central Bank.
- For the record, the current fund balance is US$1.996 million. From 2002 to the present, the Fund has increased by US$1,500 million, roughly US$250 million a year. This represents about 12 per cent of average annual energy tax collections. (I note, that this is the figure even though the Government has always deposited more than required by the formula.)
- At the current rate of deposit, and assuming no withdrawals and a real rate of return of 4 per cent, the total Fund balance would rise to a mere US$11.3 billion in the next fifteen (15) years.
- One can argue that a **more robust accumulation** will be necessary to fulfill the Fund's original objective over the long term. "Back of the envelope" calculations suggest that it will take an average annual deposit of about US$800 million, (or about 20 per cent of projected annual energy tax collections) to reach a balance of around US$25 billion by 2023 (i.e. after 15 years). Of course the increase in savings has as its counterpart, expenditure curtailment.

Is there a role for the population in the administration of the HSF?

The answer is without doubt **YES.** Without doubt, public understanding of the **importance of the HSF** and **public buy-in** to the programme are critical to the success of the HSF. And the HSF Board intends to adopt an active communications strategy.

For example, the public should be convinced of the need to put aside savings for future generations rather than to spend for current consumption.

- The communication strategy is also important to counter misinformation and misperceptions, for example, by explaining the rationale behind the transfers to the Fund and withdrawals from the Fund, when they become necessary.
- It is important, for instance, that the public understand the procedures behind the selection of external managers so as to underscore transparency and avoid the perception of special deals.

- We need to manage expectations in line with market realities, since there are going to be questions about whether we are taking too little or too much risk, or whether the Fund is earning enough.

Experience elsewhere has shown that open communication could serve to maintain support for the Fund and its objectives in good times, but particularly in difficult times.

The fact is, that this is not the Central Bank's Fund, it is the country's Fund – for you and for your children's children. In addition to ensuring that the purpose and the operations of the Fund are well understood, it is important that the public feels social ownership for the Fund, as this will foster vigilance and ensure accountability, transparency and compliance.

In the final analysis, this is a pre-condition for the Fund's success.