# Contents

**Contents** **I**

**1 Introduction** **1**
1.1 Background . . . . . 1
1.1.1 Prudence and precautionary saving . . . . . 1
1.1.2 Natural resource uncertainty . . . . . 6
1.1.3 Climatic uncertainty . . . . . 7
1.1.4 Perturbation methods . . . . . 10
1.2 Synopsis and layout . . . . . 15
1.3 Symbols and conventions . . . . . 17
1.4 Publications . . . . . 17

**2 Precautionary saving for resource price uncertainty** **19**
2.1 Introduction . . . . . 20
2.2 Principles of managing volatile oil windfalls . . . . . 22
2.2.1 Three types of funds for managing volatile oil windfalls . 22
2.2.2 What assets should the funds invest in? . . . . . 24
2.2.3 Hedging against volatile oil prices . . . . . 24
2.2.4 General economic policy . . . . . 25
2.3 Theory of managing volatile oil windfalls . . . . . 25
2.3.1 No capital scarcity: intergenerational and liquidity funds . 29
2.3.2 Capital scarcity: investing to invest . . . . . 31
2.4 Three different windfalls . . . . . 32
2.4.1 Norway: declining oil windfall, no capital scarcity . . . . 32
2.4.2 Iraq: huge and long-lasting oil windfalls . . . . . 35
2.4.3 Ghana: temporary, small oil windfall . . . . . 35
2.5 Calibration . . . . . 37
2.5.1 Population growth and technical progress . . . . . 38
2.5.2 Stochastic dynamics of the oil price . . . . . 38
2.5.3 Interest rates and interest premium on national debt . . . . 39
2.5.4 Public investment: productivity and inefficiency . . . . . 41
2.6 Estimates of intergenerational and liquidity funds . . . . . 42
2.6.1 Norway . . . . . 42

2.6.2 Dominance of Iraq's liquidity buffer . . . . . 45
2.6.3 Small intergenerational and liquidity buffers for Ghana . . 47
2.7 Capital strategy and investing to invest strategy for Ghana . . . . . 48
2.8 Conclusions . . . . . 49

**3 Case study: resource revenues in Alberta** **55**
3.1 Introduction . . . . . 56
3.2 How to build an intergenerational fund . . . . . 58
3.2.1 Policy implications . . . . . 59
3.2.2 Other choices of discount rates . . . . . 60
3.3 Oil price volatility and the case for a liquidity fund . . . . . 60
3.4 Data and assumptions for Alberta . . . . . 61
3.4.1 Extraction rates and reserve estimates . . . . . 61
3.4.2 Government resource rents . . . . . 62
3.4.3 Return on the fund and general economic trends . . . . . 63
3.5 Optimal intergenerational and liquidity funds for Alberta . . . . . 64
3.5.1 Benchmark estimates and the effects of prudence . . . . . 64
3.5.2 Comparison with the spend-all and bird-in-hand rules . . . 66
3.6 Sensitivity analysis . . . . . 67
3.6.1 Alternative production scenarios . . . . . 68
3.6.2 Effects of a lower real return on assets . . . . . 68
3.6.3 Correlation between gas and oil prices . . . . . 69
3.6.4 The plunge in oil price . . . . . 69
3.7 Conclusions and policy implications . . . . . 71

**4 Asset allocation and extraction for resource SWFs** **75**
4.1 Introduction . . . . . 76
4.2 The model . . . . . 77
4.3 Complete markets and a given path of oil extraction . . . . . 79
4.3.1 Asset allocation: leverage and hedging demands . . . . . 80
4.3.2 Consumption rules and precautionary saving . . . . . 82
4.3.3 Intergenerational equity and risk aversion: EZ preferences 83
4.4 Investment restrictions and a given path of oil extraction . . . . . 84
4.4.1 Additional precautionary saving . . . . . 84
4.4.2 Stylized illustration of oil-CAPM model . . . . . 85
4.5 Portfolio allocation and spending with endogenous oil extraction . 88
4.5.1 Optimal rates of oil extraction . . . . . 88
4.5.2 SFWs with endogenous rates of oil extraction . . . . . 90
4.6 Policy implications: Norway's Government Pension Fund Global . 92
4.7 Conclusions . . . . . 94

**5 The risk-adjusted carbon price** **97**
5.1 Introduction . . . . . 98
5.2 A DSGE model of global warming and the economy . . . . . 101
5.3 Asymptotic solutions for the optimal risk-adjusted price of carbon 105
5.3.1 Transforming to non-dimensional form and scaling . . . . 106
5.3.2 Perturbation expansion . . . . . 106
5.3.3 Perturbation solutions . . . . . 107
5.4 The optimal risk-adjusted SCC: leading-order effects of uncertainty 109
5.4.1 The optimal SCC in the absence of uncertainty . . . . . 110
5.4.2 Economic growth uncertainty and the climate beta . . . . 110
5.4.3 Climate and damage uncertainties . . . . . 111
5.4.4 Climate betas: . . . . . 112
5.4.5 Special case: logarithmic preferences . . . . . 113
5.5 Calibration . . . . . 113
5.6 Quantification of effects on optimal SCC . . . . . 115
5.6.1 Economic determinants of the optimal carbon price . . . . 116
5.6.2 Climate betas . . . . . 118
5.6.3 Comparison with other calibrations . . . . . 118
5.6.4 Accuracy of the tractable rule . . . . . 120
5.7 Conclusions . . . . . 120

**6 Discussion** **123**
6.1 Non-resource and non-climatic uncertainty . . . . . 124
6.2 Uncertain natural resource reserves and stranded assets . . . . . 126
6.3 Climate uncertainty and catastrophes . . . . . 127
6.4 Conclusions . . . . . 131

**Summary** **133**

**Samenvatting** **137**

**Biography** **141**

**Acknowledgements** **143**

**Bibliography** **145**

**A Appendix to Chapter 3: Model equations** **159**

**B Appendix to Chapter 3: Detailed description of data** **161**
B.1 Real interest rates . . . . . 161
B.2 Estimates of reserve stocks . . . . . 162
B.3 Official projections of extraction rates . . . . . 163
B.4 Extraction costs . . . . . 163
B.5 Price processes . . . . . 165

B.6 Economic and population growth . . . . . 167
B.7 Historical series of government resourcerents . . . . . 169
B.8 Initial size of the fund . . . . . 169

**C Appendix to Chapter 4** **171**
C.1 Valuing oil with exogenous oil extraction . . . . . 171
C.2 Asset allocation with exogenous oil extraction . . . . . 173
C.3 Optimal consumption with exogenous oil extraction . . . . . 174
C.4 Complete markets and exogenous oil paths: EZ preferences . . . . 176
C.5 Endogenous oil extraction . . . . . 176
C.6 Asset allocation with endogenous oil extraction . . . . . 179

**D Appendix to Chapter 5** **181**
D.1 Risk-adjusted carbon price with convex reduced-form damages . . 181
D.2 Transformation to non-dimensional form . . . . . 184
D.3 Derivation of zeroth-order solution . . . . . 185
D.4 Derivation of first-order solution . . . . . 187
D.4.1 Solution to multi-variate Ornstein-Uhlenbeck process . . . 187
D.4.2 Evolution equations for $\hat{K}$ and $\hat{E}$ . . . . . 188
D.4.3 The Hamilton-Jacobi-Bellman equation . . . . . 189
D.5 Leading-order effects of uncertainty . . . . . 194
D.5.1 Carbon stock dynamics . . . . . 194
D.5.2 Leading-order forcing . . . . . 195
D.5.3 Leading-order solution . . . . . 201
D.6 Calibration . . . . . 202
D.6.1 Asset returns, risk aversion and intertemporal substitution 202
D.6.2 Production function parameters . . . . . 203
D.6.3 Atmospheric carbon stock and uncertainty . . . . . 204
D.6.4 Curvature of the temperature-carbon stock relationship . . 206
D.6.5 Climate damages and climate damage uncertainty . . . . . 207
D.6.6 Climate sensitivity and uncertainty . . . . . 209
D.7 Accuracy of Results 2 and 2′ . . . . . 214