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Effective Management of High Oil Revenues in Transition Economies with Rich Hydrocarbon Reserves: Russia, Kazakhstan and Azerbaijan

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Abstract

The special nature of “raw material revenues” requires a special managerial approach, one that is geared towards ensuring medium- and long-term macro-economic stability. The key is to keep state expenditures and private consumption stable over the long term, as well as to prevent the oscillation of macro-economic indicators such as inflation, the exchange rate, national debt and interest rates in financial markets.

This paper reveals the macro-economic impact of oil revenues and the necessity for managing them effectively in terms of both ultimate objectives and incremental improvements. The author has conducted a comparative analysis of Russia, Azerbaijan and Kazakhstan, which are all both transition and oil economies. The charts in the addenda illustrate the importance of oil in these three countries.

Economic impacts of oil revenues

Strong economic and budgetary dependence on raw material exports presents serious macro-economic risks. Decreasing dependency on the revenues generated by unrefined natural resources requires pursuing a special economic policy. The first step is to consider medium-term and long-term prospects, whose duration is defined by the rate of change of commodity prices and the period of natural reserve depletion. The oscillation of budgetary income due to price fluctuations on the world raw material market makes it necessary to sharply increase or decrease budgetary expenditures, reconsider tax levels or borrow huge amounts to compensate for the diminishing income.

Each of these variants adversely affects the economy. As a result, during favourable external conditions, budget limits appear to be very flexible – financial surpluses are often used to finance risky or insufficiently researched projects. A significant amount of state spending ends up being ineffective in that the financing of projects or programmes initiated when states coffers are full is ceased when revenues slump. Unfavourable market conditions also exacerbate social tension and worsen tax conditions. Generally, the efficiency of resource use in a budgetary system like this turns out to be very low.

The fluctuation of export prices for commodities presents serious problems not only for the budgetary sphere. Sharp changes in currency incomes may cause the exchange, inflation and interest rates to soar.

“Dutch disease” [revenues from natural resources will deindustrialise a nation’s economy] develops during periods in which raw materials command high prices. In turn, the unpredictability and changeability of key macro-economic indicators (inflation rate, exchange rate, interest rate) – as shown in international practice – impose serious obstacles for investment and economic growth. It is therefore necessary to assess the impact of raw material revenues on the stability of the macro-economy and to accumulate budgetary reserves for expenditure during periods in which prices for the raw materials are low. The exhaustibility of the natural reserves themselves also needs to be considered. Special principles for establishing a viable budget policy are absolutely essential. Oil revenues impact the economy in other ways as well; they affect the real exchange rate, decrease the competitive potential of the non-oil sector, contribute to the non-oil budget deficit, etc.

As a rule, governments spend their own oil revenues less efficiently. The problem of managing oil revenues first emerged in the 1960s; it is therefore relatively new issue among traditional economic problems. However, once it appeared, this dilemma became very acute for the extractive countries. Their relatively short history of oil revenue management combined with numerous errors made by various governments compelled them to work out several universal rules for more effective management of the oil dollars. The key rule is most likely sterilising some of the revenue obtained from the sale of the hydrocarbons in the external market, especially if they were the product of favourable foreign-trade conditions in the world market.

The unrestrained influx of oil dollars in an economy presents a morass of difficult problems for a government. The generation of permanent inflation, the objective strengthening of the national currency in relation to the major world currencies and finally, the disproportional impact of the oil revenues on various sec-

tors of the economy (both commercial and noncommercial) all argue in favour of limiting the unobstructed flow of oil dollars into the monetary assets of the economy. In the experience of many extractive countries, which face this problem periodically, stemming the influx of oil dollars is a necessity.

Governments in oil economies seek to maximise revenue receipts and then face the consequences of uncertainty and instability in actual flows: uncertainty about the value of resources and the timing of revenues and instability of prices, whether from income-driven variations in demand, or through volume constraints from target pricing by suppliers.¹

The taxation problem is to establish a system of revenue sharing between international oil companies and governments that maximises the flow of government revenues over time. A fiscal system that efficiently taxes petroleum rent may maximise revenue flows but shift the risk of instability to the government. A government that organises macro-economic management to enable it to bear this risk will probably fare better in terms of revenue over time and set in place a macro-economic framework leading to more efficient use of petroleum revenues. The interdependence is clear: earnings from natural resources sustain the high rate of capital formation, and investment of the earnings is in turn required to sustain the exploitation of those natural resources and to diversify the capital stock into other sectors of production.²

Whether temporary booms and slumps in petroleum revenue or major sectoral shocks are at issue, the extremes of possible responses can be illustrated by simple national accounting scenarios. When a shock lowers national income, then either absorption or the trade surplus must fall. Either domestic expenditure must be cut or a trade deficit must be financed. A petroleum revenue boom requires that absorption is increased or that a trade surplus leads to the accumulation of foreign financial assets. In other words, a revenue boom has to be absorbed somehow: by saving abroad, raising imports, reducing savings or increasing investment. A slump requires the same process in reverse. General economic stability has value because it reduces investors' risk premia, avoids disruption of public and private investment and strengthens a government's international negotiating and trading position. Stability is also vital to poverty reduction: those without assets and skills tend to suffer the most harm from instability, controls or rent-seeking behaviour. Fiscal and monetary instability jeopardises any programme of social transformation or redistribution. Are there then rules for keeping medium-term stability in an environment of booms and slumps? First, spending should be kept on a sustainable growth path and excess revenues from abroad should be saved. Second, conservative (below median) forecasts of future revenues should be used. Third, the foreign asset position should be allowed to fluctuate, whereas domestic absorption should be kept steady. When these rules are heeded, there is no need to "fine tune"; the automatic stabilisers can be relied upon in both upswings and downturns. When in doubt, governments should save money.

A general approach to effective management of oil revenues

The above-mentioned reasons for the necessity of sterilising part of the oil revenues are based upon macro-economic or stabilisation principles. In saving some of the oil dollars, the government will be able to resolve problems in economic development, ensure macro-economically balanced development and free itself from the various kinds of fluctuation that inevitably rock the extractive countries during periods of unstable prices on the world market. However, sterilising revenues also fulfils the original goal of reserving some of the petroleum income for future generations. Hydrocarbons are considered non-amended natural resources, and future generations have the same right to them as current citizens. Historically, setting aside funds for future generations has been important for the extractive countries. The funds reserved for this purpose have therefore taken priority over a stabilisation fund. But generally, special funds to store and manage petroleum revenues (nonrenewable resource funds) are stabilisation, savings or precautionary

1 Oil Revenues and Fiscal Policy. Philip Daniel and Rolando Ossowski, Fiscal Affairs Department, International Monetary Fund, Petroleum Revenue Management Workshop, Luanda, Angola, May 2006. p. 4.

2 Yelena Kalyuzhnova, Michael Kaser. Prudential management of hydrocarbon revenues in resource-rich economies. UN Economic Commission For Europe, Economic Analysis Division. No. 5. December 2005, p.2.

funds. A stabilisation fund shields the economy from revenue instability. A savings fund stores wealth for future generations. A precautionary fund preserves revenue in the face of uncertain prospects or in situations where absorptive capacity is poor. Funds are no substitute for good fiscal management, however. Many important producers operate without funds (e.g., the United Kingdom, Saudi Arabia, Indonesia and Australia). The integration of any fund with overall fiscal management is vital. There should be a consolidated budget framework (domestic expenditure only through the budget), a liquidity constraint on the general budget (no borrowing that offsets savings in the fund) and strict limits on domestic investment by the fund. The timing of petroleum revenues does not follow a known path; fiscal management, perhaps supported by funds, can shift the path of absorption and reduce the effects of uncertainty. The key elements for the efficient management of oil funds seem to be: accountability to elected representatives; independent audits of transactions and activities; a clear investment strategy, relying for the most part on investment in foreign assets; benchmarking of the desired investment returns in different market segments; and competition in the appointment of investment managers.

Oil revenues, like any other assets, need expenditure management rules if they are to be used effectively. The prominence of petroleum revenues, coupled with the frequent desire to earmark them, makes rules that specifically apply to petroleum revenues vital. These rules cover adequacy of data, budget preparation, budget execution and cash management arrangements. Earmarking for specific expenditures and disbursement through extra-budgetary funds may, exceptionally, have a role, but are usually best avoided. Does use of an extra-budgetary fund and earmarking create better public support for saving and targeted spending? Extra-budgetary funds can increase efficiency by simulating private market conditions where levels and standards of service are linked directly to fees or charges, for example, management of road user charges in a fund dedicated to road maintenance. This benefit, however, hardly applies to the management of petroleum revenues. More plausible would be the use of petroleum revenues to provide a consistent source of funds for expenditures that yield high benefits but are often unrecognised and subject to cuts. Indeed, accumulating monies for future generations is an incomparably simple task, and in 1970s, such funds were created in several Arab countries (e.g., Kuwait and Oman). At that time, the task of macro-economic stabilisation in the world, especially in the countries considered here, was not such a pressing issue as in the 1980s in more developed countries. It is not difficult to see that in terms of their management, the accumulated resources did not require resolving complex macro-economic tasks. The only problem for the governments was to keep the fund's resources in a more reliable form, mostly in the first-class, reliable banks of the world in a worldwide currency (USD) or in properties acquired in developed countries. In these cases, it was not necessary to devise a long-term strategy for the management of the fund's resources or to conduct an annual study of macro-economic views to find the optimal proportion of monies to spend in the domestic economy. Such rules of accumulation were usually used for a fund reserve in the ordinary sense rather than as a tool to effect macro-economic development.

However, the influence of inflation on the world market during various periods, the development of securities markets and complications stemming from macro-economic management effectively presented the governments with the more difficult task of transforming the created funds from passive reserves into more active instruments of macro-economic management. At the same time, there appeared new, more ambitious funds that adopted the aggressive goals of sterilising finances to prevent the onset of the "Dutch disease" and of concurrently assisting in ensuring high rates of economic development. A typical example of this is the establishment of the State Oil Fund of Norway in 1990, which radically changed the traditional thinking with regard to these institutions. Norway has been saving its oil-and-gas-boosted budget surpluses in a government petroleum fund, which is invested abroad and is now valued at more than \$250 billion.³

Immediately thereafter, the oil funds began to evolve into full-fledged institutions of economic development. In the hands of the governments, the funds were a supplementary and very important tool to significantly improve the key parameters of macro-economic balance and, depending on the complicated conditions in the world and domestic markets, to manipulate the resources of the funds to manoeuvre

3 <https://www.cia.gov/library/publications/the-world-factbook/geos/no.html>

and provide necessary stimulation to the economy. Via the creation of stabilisation funds, the function of accumulating monies objectively passes onto the second level and becomes a routine task, which is now executed more effectively. In any case, existing funds are primarily rated not only for sterilising and reserving surplus petrodollars for future generations, but also for transforming the revenue into an integral part of macro-economic management.

The necessity for establishing stabilisation funds becomes more apparent if there are limitations on borrowing (there is an opportunity to lend in a favourable atmosphere, but it is impossible to borrow when revenues dip too low). In addition, one variant of creating stabilisation funds may be to consider them as insurance reserves. If the government is negatively pertinent to the risk, then it stands ready to decrease the average level of state expenditures, provided that several agents neutral to the risk provide a guarantee to fully reduce expenditures. The critical aspect vis-à-vis establishing a stabilisation fund is to define the formulas of transferring finances. The formulas or rules with respect to transfers to the stabilisation fund should be based on the factual dependence of budgetary income on the world prices for the exported resources. Moreover, it is necessary to determine a reference price according to which the decision will be taken whether the income will go to the Fund or to the state budget. It is well known that world prices are not stationary. This means that certain difficulties may emerge in the activities of the stabilisation funds intended to smooth the incomes – resolving the current tasks in the long term mainly depends on how favourable price conditions are over the next few years, and even then, there is no guarantee that expenditures will be fully smoothed in the future. In this sense, the stabilisation funds may be used only as a short-term tool to resolve the issues at hand.

Azerbaijan, Kazakhstan and Russia

On a par with changes in the economic situation in the West, fundamental policies were reshaped in the former Soviet Union. Three heavy hitters – Azerbaijan, Kazakhstan and Russia – managed to enter the arena. After the collapse of the USSR, all three countries experienced economic, political and social problems. Although the countries possessed adequate amounts of raw materials, after the collapse of the Soviet empire, the majority of external economic links was broken, which served to exacerbate the aforementioned problems. These countries were forced to re-establish the links one by one, with each other as well as with their western partners. It is no secret that the fuel and energy sector – more concretely oil and gas production – in these three countries is one of the only sectors that really works. The governments expected to receive huge revenues in the long term by attracting foreign investment. Wise use of the profits obtained from the development of the oil and gas industry was one of their principal goals. However, at that time, none of the above-mentioned countries was experienced in managing the forthcoming revenues.

The necessity of establishing an oil fund in Azerbaijan had been emphasised by the international oil companies long ago – even before the contracts were signed. Oil is the most important natural resource being exploited in Azerbaijan. Sitting atop 7 billion barrels of oil, the country generates 84% of its exports and 42% of its GDP from crude oil and petroleum products. Following year-on-year growth of oil production and rising oil prices, oil revenue has reached USD 3 billion. In the framework of the “Contract of the Century” alone, oil incomes are expected to surpass USD 150 billion by 2025. For comparison, Azerbaijan’s current state budget comprises USD 4 billion⁴.

In order to resolve the tasks it faced, the Azeri government decided to study the international experience of the countries that had already established similar funds. The State Oil Fund of Azerbaijan Republic (SOFAZ) was founded in 1999. The Fund was originally created as an off-budget institution aimed at managing oil and gas profits by nurturing the interests of the country and future generations – in other words, accumulating monies. In the early stages, the Fund functioned as a fully independent institution by virtue of not having any links with the state budget. It continued as such until 2003. Thereafter, following several

4 <http://www.azstat.org>; <http://www.az-customs.net/eng>

amendments pertinent to its activities, transfers were made from the SOFAZ to the state budget on an annual basis. Thus, the Fund began to more actively implement a stabilisation function as well.⁵

Another former Soviet republic to establish a reserve fund was Kazakhstan. Because large oil reserves are one of the main sources of material wealth in this country, oil naturally became a transforming product and a key export. As the non-raw material sector of the Kazakh economy has developed weakly and it is impossible to impose internal structural stability upon it, the similar economic impacts of the oil revenues make the economy strongly vulnerable to the oscillation of world oil prices. The National Fund of the Republic of Kazakhstan was created in 2000 in order to ensure the macro-economic stability so important for an economy dependent on the export of certain kinds of raw materials as well as on sharp and unpredictable fluctuations in world prices.⁶ The key task in creating the Fund was to set aside some of the huge revenues generated by these products and later use the monies to fulfil the state's budgetary obligations by ensuring the stability of the revenues when world oil prices went down sharply.

The first transfers to the Fund were made in May 2001. The main source of income to the Fund came from the above-mentioned profits from the raw material sector as defined by the government of Kazakhstan. The Fund's assets were mainly put into foreign financial tools. The National Fund's assets have been divided into two portfolios: stabilisation and savings. The first portfolio is invested into the highly liquid, reliable assets of the money market of countries with high credit ratings. In order to diversify and obtain higher profits in the long-term, the second portfolio is invested into both debt and share financial tools circulating in the developed countries of the world.

Work is presently being carried out to ensure the transition (since 1 July 2006) to a new method of the Fund to be envisaged by the Rules on the Formation and Use of the Fund's finances in the medium term. At the present time, direct tax incomes generated from oil enterprises, the privatisation of State properties (to be owned by the Republic) related to the mining and manufacturing industries and from the sale of agricultural land plots are transferred to the Fund on a daily basis. Since the restructuring of the National Fund on 1 July 2006, Kazakhstan has been applying a model of a balanced budget in which all payments from the oil sector are fully transferred to the Fund. Monies are disbursed to finance strictly limited portions of the budget expenditures only after this transfer has taken place.

According to the State Socio-Economic Development Programme, in the medium term, Kazakhstan will implement "a fiscal policy ensuring that the growth rates of State budget expenditures will be balanced with growth rates in nominal GDP, and will gradually decrease the non-oil deficit". As of 1 August 2006, the assets of the National Fund exceeded USD 10 billion. The amount of the guaranteed transfers from the National Fund for financing the expenditures is supposed to be reduced from 3.86% of the GDP in 2007 to 3.01% of the GDP in 2009⁷.

The third example from the former Soviet Union to apply the experience of its neighbours near and far is Russia. Its Stabilisation Fund was established in 2004. The State's incomes from oil production and exportation are transferred to the Fund when the world oil prices exceed a certain pre-defined price level. Initially, prices were set at \$20 per barrel, but starting in 2006, they were increased to \$27 per barrel⁸. Thus, the budget receives the revenues if oil prices are equivalent or lower to the confirmed prices, but all surplus goes into the Stabilisation Fund. The systematic process of accumulating and using the revenues is realised through the Stabilisation Fund. The Fund ensures a special protocol for using the revenues by providing guidelines for carrying out efficient fiscal and monetary policies. The existence of the Stabilisation Fund does not guarantee the consistent realisation of this policy, but at the same time, protecting the economy from the oscillation of external market conditions would be virtually impossible without the mechanism of the Stabilisation Fund. One characteristic feature of the Russian Fund is that it enables the government

5 Ingilab Ahmadov. Oil gloss of economy. Baku, 2006, pp.132.

6 Ingilab Ahmadov. Oil gloss of economy. Baku, 2006, pp.133.

7 <http://www.nationalfund.kz>

8 Ingilab Ahmadov. Oil gloss of economy. Baku, 2006, pp.134.

to smooth over short-term oscillations of world prices. The significance of the Fund's mechanism is that it functions as a stabiliser: the income deposited into the Fund is directly commensurate with the revenues generated by the oil sector.

Billions of Russian petrodollars are slated to be invested in shares of international companies for the first time, boosting Russia's presence in financial markets. Investment in these equities is part of a plan to split Russia's Stabilisation Fund – which has amassed \$108 bn of windfall oil tax revenues since its creation in 2004. A reserve fund will be kept at 10% of the gross domestic product – enough to support budget expenditures for three years even if oil prices were to halve. Any surplus after using a fixed portion of energy revenues for budgetary spending will go to a “future generations” fund for long-term projects. The reserve fund is projected to hold nearly \$142 bn and the future fund \$24bn when the division occurs, and both can continue to grow rapidly if energy prices remain high. The reserve finances would be invested in a conservative portfolio of government bonds – similar to the Stabilisation Fund. But the other fund could be invested in higher risk assets, with the aim of maximising returns. Russian or western managers could be appointed to manage the fund – a contract likely to attract vigorous competition. The plan demonstrates the turnaround in Russian public finances, fuelled by record energy prices, since its 1998 crisis. Russia has built gold and foreign exchange reserves of \$356bn – the world's third biggest – in addition to its petrodollars fund⁹.

Splitting the stabilisation monies was approved by the Russian parliament April 2007 following its endorsement by President Putin. In addition to its \$356bn in gold and foreign exchange reserves, Russia has \$108bn in a stabilisation fund based on the Norwegian model. This fund has received every dollar of oil revenue above a certain price since 2004, even after paying off debts (including Russia's remaining \$22bn to Paris Club creditor nations last year). High oil and gas prices have buoyed the turnaround. But economists say that the country's strict fiscal management deserves praise nevertheless; pursuing a conservative fiscal policy at a time when revenues are increasing at such speed is no mean feat. Russia is now entering a new stage. A reserve fund will be kept at 10% of the gross domestic product, which topped \$1 trillion last year. That will be enough to maintain projected budget spending for three years even if oil prices halve to \$30 a barrel. A “future generations” fund, the ultimate rainy-day piggy-bank, will absorb anything left over after topping up the reserve fund to the required level from a predetermined transfer from oil and (for the first time) natural gas tax revenues. The transfer has been set at 4.9% of GDP this year and at 6.1% for 2008, but will fall to 3.7% annually starting in 2011; this level is considered sustainable even if oil prices halve. The new funds will be created next February 1; the reserve fund is projected to receive \$142bn and the future generations fund \$24bn. Russia is developing a security system for the reserve fund and restricting the use of oil and gas revenues expenditures; these measures will help reduce inflation and stabilise the exchange rate. Inflation finally fell to a single digit last year, to 9%, for the first time since the Soviet collapse, and could drop below this year's 8% target. Oil and gas revenues' share of the federal budget will fall by 3 percentage points to 5.3% in 2010, reducing budgetary dependence on energy just as the government is trying to wean the broader economy off reliance on oil and gas. Meanwhile, Russia has adopted a three-year budget framework. While the budget surplus is expected to shrink from last year's 7.4% to 0.1% by 2010, average real spending growth should fall from 18% in the past three years to 5.6% in the next three¹⁰. Economists say that an important shift is under way. After living hand to mouth for so long, Russia can at last plan for the future. And it is finally shifting from hoarding to spending, meaning ordinary Russians will gradually start to see more of the country's energy wealth. Fixed capital investment is forecasted to more than double from last year's sum to \$357bn by 2010.¹¹ Some see dangers ahead. Russia's financial boom could end painfully as it reaches capacity limits in an expansion fuelled largely by foreign credits.

9 http://www.ft.com/cms/s/7a553420-f289-11db-a454-000b5df10621,dwp_uuid=697b055c-4d13-11da-ba44-0000779e2340.html

10 http://www.kremlin.ru/appears/2007/03/09/1351_type63373_119318.shtml

11 http://www.ft.com/cms/s/6ad9ce08-f27e-11db-a454-000b5df10621,dwp_uuid=697b055c-4d13-11da-ba44-0000779e2340.html

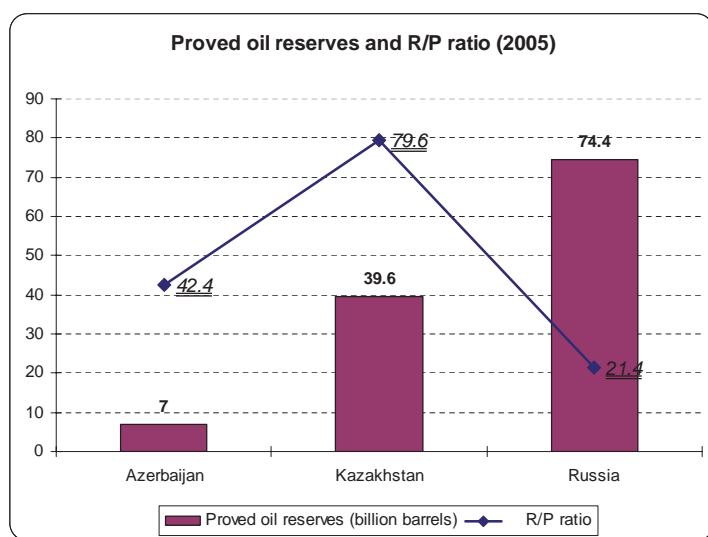
Experts see “no significant financial risks for Russia under any realistic scenario” in the next three years, however.

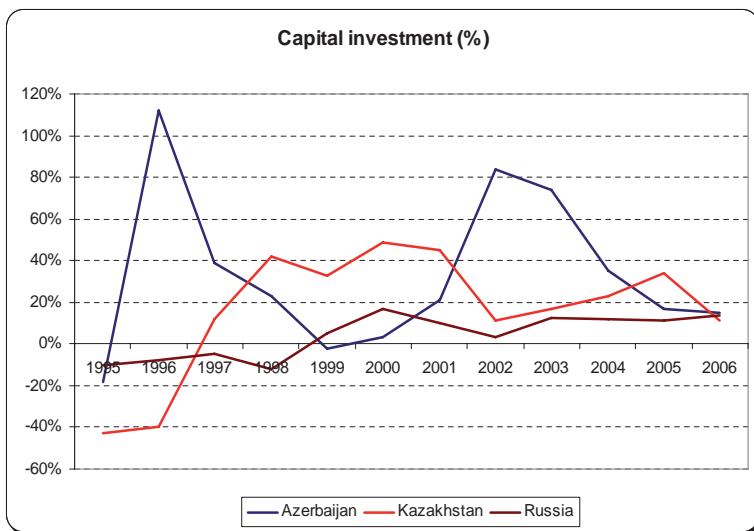
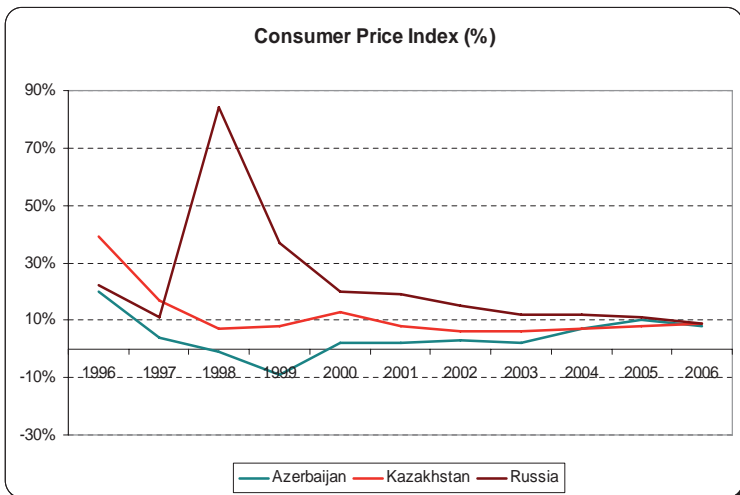
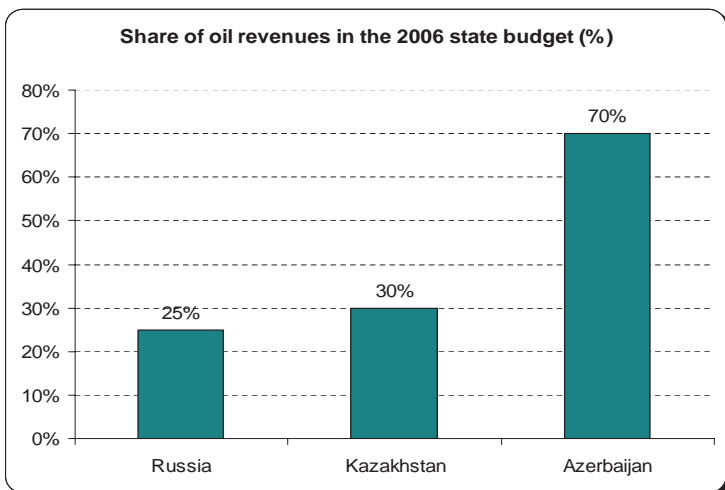
Russia, Kazakhstan and Azerbaijan have already joined the Extractive Industry Transparency Initiative and are actively working under this framework.

Conclusion

The common wisdom is to equally distribute the revenues from non-amended natural resources over the period of their exploitation. This management approach envisions the full or partial reserve of the revenues when exploitation levels of natural resources are on the upswing and when the raw materials command high prices. The approach also stipulates the use of the reserved monies in periods of reduced production or a fall in prices, that is, pre-distribution of budget resources over time. This kind of revenue management is useful for moderating state expenditures and ensuring long-range macro-economic stability. It should be noted that each of the funds in these three transition countries possesses special characteristics. Each country has its own unique socio-economic and political situation as well as differing conditions and reasons leading to the creation of the funds. In the most concise form, the functions of all these funds, without exception, may be ranked as follows: *accumulating income for future generations; ensuring macro-economic and financial stability; ensuring liquidity of the state; raising transparency of state expenditures; more accurately reflecting the base level of the budget deficit; fighting corruption; protecting the monies from politicians.* Thus, with respect to the importance of the mission of the oil funds, it must be mentioned that many of them continue to suffer from ineffective management and especially from the obsolete macro-economic instruments in the hands of the government.

Addenda





Statistical source: <http://www.cisstat.org>; <http://www.bp.com>

Charts created by the author.