

Fiscal Management in Oil-Producing Countries

Presentation to USAID Workshop
“Promoting Economic Growth in a New Era”
Washington, D.C.—July 2004

Rolando Ossowski
Fiscal Affairs Department
International Monetary Fund

This presentation should not be reported as representing the views of the IMF. The views expressed are those of the author and do not necessarily reflect the views of the IMF or IMF policy.

Outline

- Challenges posed by oil revenue in oil-producing countries.
- The nonoil balance and the overall balance
- The need to avoid a procyclical fiscal policy
- Sustainability and accumulation of financial assets
- Some institutional mechanisms
- Conclusions

Crude Oil Spot Prices, 1970-2004 1/



Sources: IMF, International Financial Statistics (Washington, various issues); and IMF staff estimates.

1/ Average of U.K. Brent, Dubai, and West Texas Intermediate. Constant prices deflated by the manufacturing unit value at January 2004 prices.

Introduction

- Some stylized facts for many developing oil-producing countries:
 - disappointing growth and continued poverty
 - generally weak economic performance
- Some suggested explanations:
 - Dutch disease
 - Enclave nature of the (mature) oil industry
 - Oil-financed postponement of growth-enhancing reform
 - Competition for oil rents from fiscal pressure groups/rent seeking
 - Institutional quality issues
 - ***Characteristics of fiscal policy***

Oil-Producing Countries are not the Same

- Importance of oil
- Development of nonoil economy
- Maturity of the oil industry
- Ownership of oil industry and fiscal regime
- Financial position of the government (net debt, liquidity)

Challenges Posed by Oil Revenues

- The revenue stream from oil:
 - *is uncertain and volatile*
 - *originates abroad*
 - *will eventually dry up*
- Governments must decide
 - how expenditure can be planned and insulated from revenue shocks--how to inject oil resources into the domestic economy (stabilization)
 - to what extent resources should be saved for future generations (saving)

The Nonoil Balance

- The fiscal nonoil balance is a key fiscal indicator in oil-producing countries. It should figure prominently in the budget and fiscal analysis.
- Why is the nonoil balance important?
 - Indicator of government demand
 - Measure of injection of oil revenue into the domestic economy
 - Measure of fiscal effort and underlying policy stance
 - Important input into the analysis of fiscal sustainability
- Scaling factors: GDP, nonoil GDP, nominal, real terms. Sometimes what you see is not what you get.

The Nonoil Balance (2)

- Is the nonoil balance presented and discussed in the budget?
- Does the nonoil balance figure prominently in public discussion of fiscal policy?
- Do not confuse improving overall balances due to higher oil revenue with “fiscal consolidation” or “fiscal adjustment”.
- With rising oil revenues, a fiscal expansion (deterioration in the nonoil balance) can be masked by an improving overall balance, making everybody happy for a while—until the next downturn occurs.

The Nonoil Balance and Transparency

- Countries should be encouraged to highlight the nonoil balance in budget documents used in parliamentary and public discussion.
- A clear presentation of the nonoil balance would help:
 - Make the use of oil revenue more transparent
 - Delineate policy choices more clearly
- A greater focus on the nonoil balance would help develop constituencies in support of prudent policies, thereby contributing to a less procyclical and more long term-oriented fiscal policy.

The Overall Balance

- The overall fiscal balance is the relevant indicator for assessing the government's net financing requirement and provides information on fiscal vulnerability.
- How is the overall balance financed?
 - Domestic financing
 - External financing
- May not be a good pointer for the impact of fiscal policy on domestic demand or the government's adjustment effort.

Need to Avoid a Procyclical Fiscal Policy

- If a country behaves procyclically during oil upturns, it will probably be forced to be procyclical during oil downturns—because it may not be able to finance the “bad times”.
- Do oil producers avoid the temptation of increasing expenditure during the upswing?
- Fiscal policy should be adjusted smoothly in the upswing—and in the downturn if feasible.
 - Smoothness applies to the nonoil balance, particularly expenditure.
- There are macroeconomic and fiscal benefits to be derived from fiscal prudence and smooth adjustment.

Macroeconomic Considerations

- There is a strong macroeconomic case for smoothing fiscal expenditure and minimizing the transmission of oil price volatility to the nonoil economy.
 - Impact of fiscal volatility → volatile aggregate demand.
 - The costs of large and unpredictable changes in fiscal spending and the nonoil deficit include:
 - The need to reallocate resources to accommodate changes in demand and relative prices.
 - Real exchange rate volatility.
 - Increased risks faced by investors in the nonoil sector, with adverse effects on growth, poverty reduction, and the creation of jobs.

Fiscal Policy Should Support the Broader Macroeconomic Objectives

- Need to foster an environment conducive to nonoil growth and development
 - Economic policy should help minimize real appreciation of the currency, fight inflation, and seek to achieve low interest rates.
- Example: fiscal policy (nonoil deficit) may need to be tightened during an oil boom—no need for fiscal policy to add to the fire during oil upswings.
 - Oil income comes onshore.
 - Procyclicality of oil prices and the *nonoil* economy.
 - Monetary policy may be inadequate, costly, or self-defeating.
 - Fiscal policy can help the sterilization process.

Fiscal Considerations

- It is costly and inefficient to adjust spending rapidly and abruptly.
- The level of spending should be determined in light of its likely quality and the capacity to execute it efficiently.
 - The sudden creation or enlargement of spending programs is risky.
 - Increases in spending may exceed the government's planning, implementation, and management capacity → waste.
 - Spending should not rise faster than transparent and careful procurement practices will allow.
- Spending typically proves difficult to contain or streamline following expansions. Expenditure becomes entrenched and takes a life of its own. Drastic spending cuts may lead to social instability, discouraging investment and reducing future growth.

Size of the Nonoil Deficit

- How large can the nonoil deficit be?
- Factors to take into account:
 - macroeconomic objectives
 - short-run vulnerability
 - government wealth, including oil in the ground and net accumulated financial assets
- While in some countries relatively large nonoil deficits may be sustainable, in other countries there is a need to reduce the nonoil deficit due to vulnerability and sustainability considerations.

Sustainability and Accumulation of Financial Assets During the Period of Oil Production

- Sustainability
 - Oil revenue will run out
 - Permanent income: annuity value of oil
 - Intergenerational issues
- Portfolio transaction
 - Swap oil assets for financial assets
 - Oil revenue is akin to financing
- Net financial liabilities and sovereign premiums

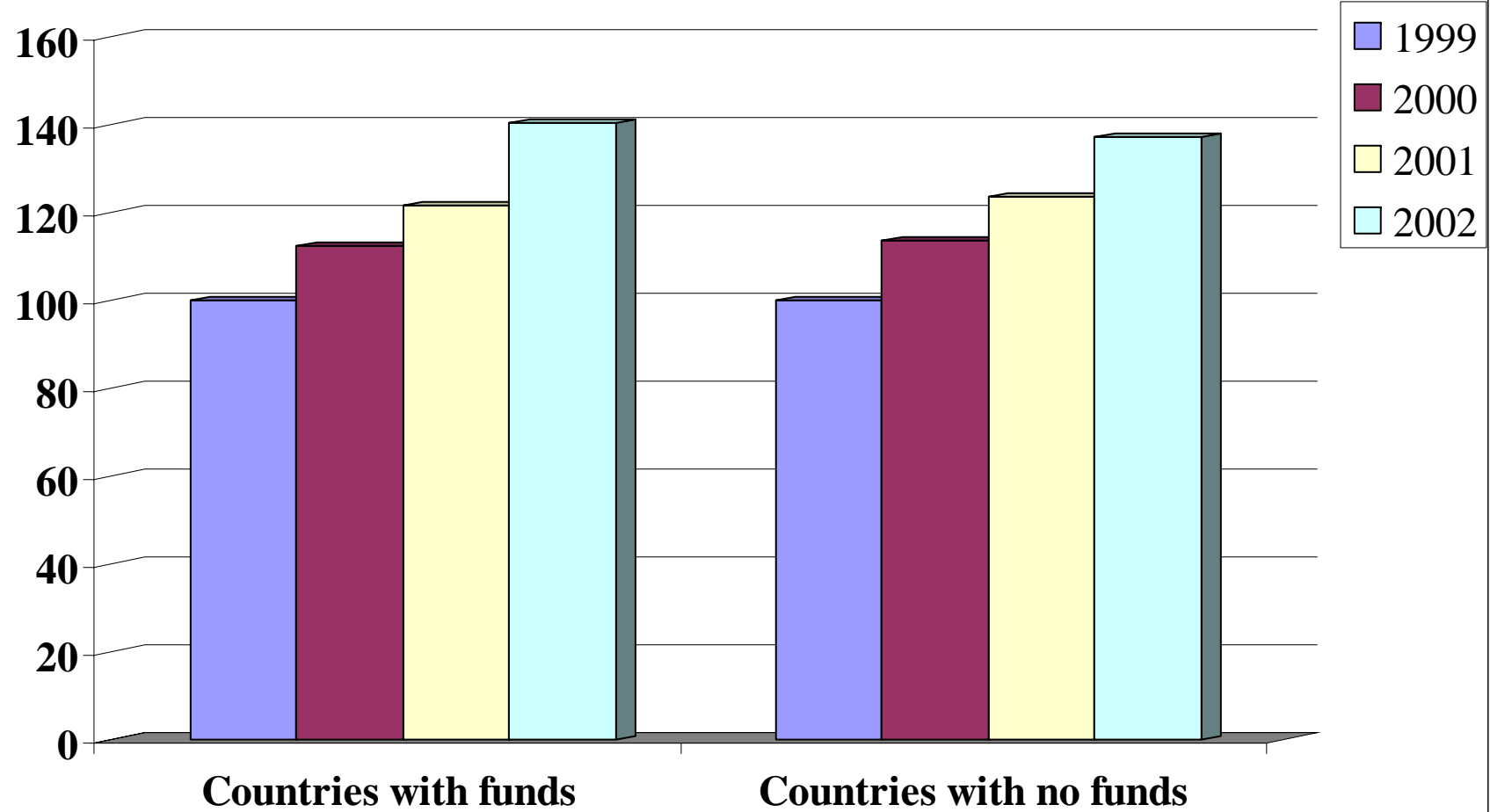
Oil Funds (1)

- Most important types of funds:
 - Contingent
 - Revenue-share
 - Financing fund
- The operational rules of funds can be flawed—the fund will not necessarily deliver the fiscal benefits hoped for, but may hamper fiscal policy and asset and liability management.
- Oil funds should not have the authority to spend. Avoid dual budgets: all spending should be transparently on budget.
- Oil revenues should not be earmarked—there should be genuine competition for fiscal resources.
- Governance and transparency (including performance evaluation, audit, and disclosure) are critical.

Oil Funds (2)

- Operational and institutional design matters a lot.
- Do not confuse oil funds with fiscal rules.
- Oil funds are not a panacea—international experience is mixed.
- Norwegian Oil Fund: transparency objectives; does not hamper fiscal policy or asset management.

Central Government Expenditure in Real Terms, 1999-2002 (1999=100, deflated by the CPI)



Medium-Term Expenditure Frameworks

- MTEFs can help limit the extent of short-run spending responses to rapidly-changing oil revenues.
- They can allow a better appreciation of future spending implications of current policy decisions—including future recurrent costs of capital spending.

Fiscal Rules

- Attempt to insulate fiscal policy from political pressures.
 - By placing restrictions or limits on fiscal variables (such as deficits, expenditure, debt), rules seek to constrain fiscal policy.
- The design of fiscal rules in oil-producing countries must take into account their specific fiscal characteristics.
- Rules should aim at decoupling expenditure and the nonoil deficit from the short-term volatility of oil revenues. But many oil-producers are liquidity-constrained.
- A sound fiscal management framework is a necessary (not sufficient) condition for the success of a fiscal rule.
- Fiscal rules are no stronger than the will of the political class to abide by them.

Conclusion: Prudent Fiscal Policy is Crucial for Good Economic Performance

- Put in place fiscal strategies to break the procyclicality between oil prices and expenditures.
- Pay attention to the nonoil balance.
- Target prudent and relatively stable nonoil deficits.
- If necessary, pursue fiscal consolidation to reduce vulnerability and strengthen fiscal sustainability.
- Establish sound budgetary systems.
- Develop medium-term budgetary frameworks.
- Have a long-term horizon.
- Enhance fiscal transparency, so that everybody can see how oil revenue is used (or misused).