The Recent Oil Price Cycle: Macro-Fiscal Challenges of Managing Volatile Extractive Industries Revenues

Extractive Industries Week: Improving EI Benefits for the Poor

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Outline of the Presentation

Part 1

- Fiscal Management Challenges in Countries Dependent on Extractive Industries Revenues
- Special Fiscal Institutions (SFI) for Fiscal Policy Management
- Strengthening Fiscal Management in EI Dependent Countries
  - Medium-Term Fiscal Planning and Risk Analysis
  - Quality of Spending

Part 2

- Recent Fiscal Developments in OPCs: Fiscal Policy Response to the Recent Oil Boom
- Current and Prospective Fiscal Challenges:
  - Sharp Fall in Oil Prices
  - Global Financial Crisis

Fiscal Management Challenges in Countries Dependent on EI Revenues

- Special characteristics of natural resource revenues:
  - Volatility and uncertainty
  - Exhaustibility (sustainability and intergenerational equity issues)
  - Originates largely from abroad (absorption, Dutch disease)
  - Dependency (large share of government revenues)
- Create challenges for design and implementation of sound macro-fiscal policies.
  - Key factor: Transitory vs. permanent changes?
- Political economy and institutional constraints

Special Fiscal Institutions for Fiscal Policy Management

To help overcome these fiscal policy challenges...

- Many commodity countries, particularly OPCs, have established "special fiscal institutions":
  - Commodity/oil funds
    - Stabilization
    - Savings
  - Fiscal Responsibility Legislation
  - Fiscal rules
  - Conservative budgetary oil prices

Experience with SFIs?

A major IMF FAD study (2008)[1] found that...

- SFIs, by themselves, have not overcome policy constraints to achieve sustained improvements in fiscal management
- Econometric results: SFIs have had no significant impact on the non-oil balance or expenditure dynamics
- SFIs have been more successful where there was a broad political consensus about fiscal objectives

1/ See IMF Occasional Paper 260, Managing the Oil Revenue Boom: The Role of Fiscal Institutions.

Key Issues with SFIs

- Funds
  - Operational rules—difficult to define, easy to change
    - Changing circumstances, volatility, permanent vs. temporary changes
  - Fragmentation of financial management
    - Earmarking / extrabudgetary spending by funds
    - Transparency / accountability rules
- FRLs / Fiscal Rules
  - May contribute to pro-cyclicality
  - May become too complex—add new rules at the margin
  - Often changed or bypassed

IMF Advice for Strengthening Fiscal Management in EI Countries

Focus on the quality of institutions…

- Medium-term fiscal frameworks (MTFFs)
  - Link annual budgets to longer-term objectives
  - Clarify medium-term implications of current policies
- Incorporate risk assessments and stress tests
- Improve PFM—improve the quality of spending
  - Budget planning, accounting and classification, internal audit and control, reporting
  - Fully integrate investment spending
  - Consistency with institutional capacity

IMF FAD Technical Assistance

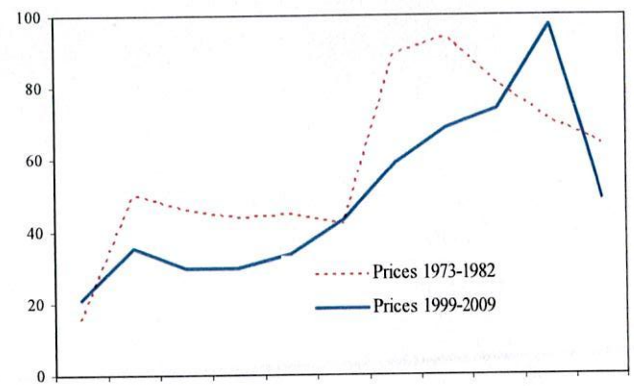
- Macro-fiscal
  - Institutional arrangements for macrofiscal analysis
  - Fiscal-federalism / revenue sharing arrangements
- Public financial management
  - Comprehensive TA
- Special fiscal institutions—funds, rules, FRLs
- Extractive Industry Revenues
  - Tax policy and regimes
  - Revenue administration
- Expenditure policy: pricing, subsidies, targeting

Recent Oil Boom: Fiscal Policy Response – Overview

- Focus on subset of OPCs
  - Fiscal oil revenue ≥ 25 of total revenues
  - Excludes GCC countries and Norway
  - Mostly low- and middle income countries ("vulnerable")
- Oil prices: a historical perspective
- Use of increased oil revenue
- Evolution of spending

Oil Prices—"*...haven't we seen this movie before?*"

Figure 1. Real Oil Prices
(US$ per barrel at 2008 prices, IMF WEO basket)

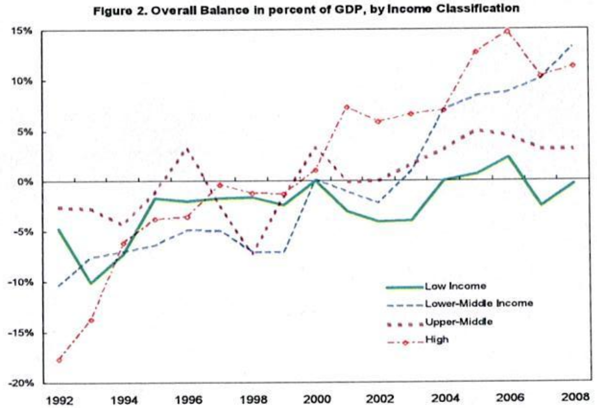


2003-2008: Improving Overall Fiscal Balances...*with some differences*

Developments

- ***Broad gains:*** Overall surplus rose with higher prices for all groups
- ***Development needs:*** LICs' position improved more gradually
- ***Vulnerability:*** Some countries barely recorded balanced position in 2008, in spite of high prices

Figure 2. Overall Balance in percent of GDP, by Income Classification

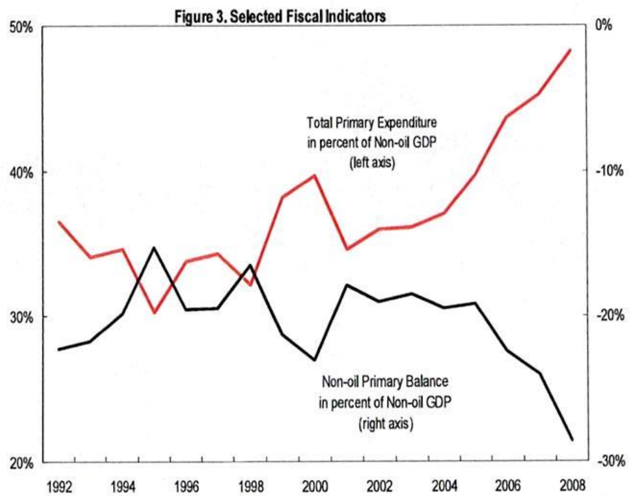


Use of the Revenue Windfall ...*Saved or Spent?*

Findings for 2003-08:

- Cumulative increase in non-oil primary deficits (NOPD) relative to cumulative change in fiscal oil revenue
  - NOPD: from 20 percent to 30 percent of non-oil GDP
- On average, OPCs "used" half of the revenue increase
  - Higher spending
- Negative correlation between the use of additional revenue and income / development level of the OPCs
  - LICs: 75 percent

Higher Spending drove the NOPD

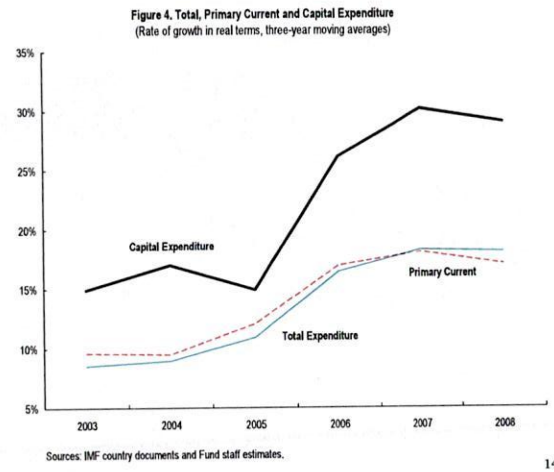


How was the money spent?

- Spending grew (and accelerated)
- Capital spending rose sharply… across all groups
- Capital spending accelerated from 2003 to 2008

Questions:

- Quality?
- Sustainability?
- Vulnerability?



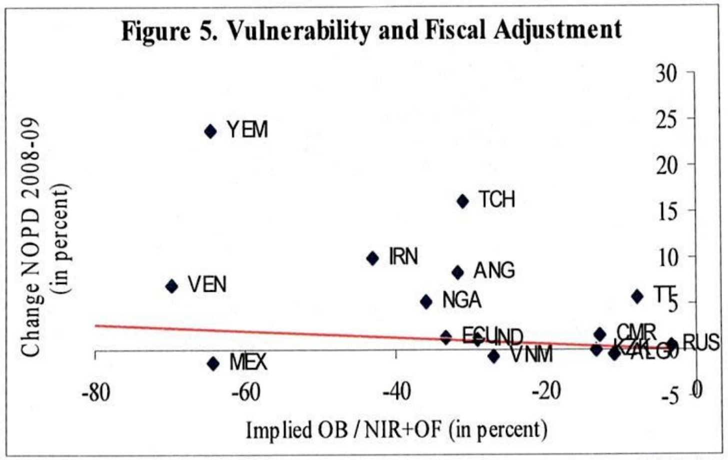
Current Context: Sharp Fall in Oil Prices

- Price shock
  - Drop from \$97/bbl in 2008 to \$50...*or lower?*
  - Near-term prospects? 2010-14: \$52-\$67/bbl
- Oil revenue shock
  - 8½ percent of GDP on average
  - Rule of thumb: US\$10/bbl → 3 percent of GDP
- Shift from large surpluses to fiscal deficits
- Exposes vulnerabilities?

Preliminary Vulnerability Assessment

- Price/revenue prospects...and *no adjustment*
  - Swing from 8 percent of GDP surplus in 2008 to 3 percent deficit in 2009, on average
  - 16/21 countries would record overall fiscal deficits
    - > 10 percent of GDP—Angola, Algeria, Iran, Nigeria, Sudan, Venezuela, Yemen
- Impact on reserves
  - Countries with deficits would have to use, on average, over half of international reserves + oil savings
  - Import coverage below 3 months for 6 countries
- Risk of continuation in 2010 and beyond

Preliminary Vulnerability Assessment



Are countries adjusting?

- Most recent Fund forecasts...
- ...suggest *limited adjustment so far:*
  - Simple "no adjustment" scenario: 3 percent of GDP average overall deficit
  - January WEO: 2½ percent of GDP

Are countries adjusting? WEO + February desk survey

- No adjustment in some countries (Algeria, Congo)
  - Draw-down on reserves; domestic borrowing
- "Wait-and-see" in others, particularly those with accumulated savings (Angola, Azerbaijan)
  - Some very initial consideration of possible spending cuts
    - *...likely focused on capital investment*
- Revenue sharing as "adjustment" (Nigeria, Sudan)
  - Outcome depends on how subnationals react
  - Lack of transparency / predictability may be a concern
- Major adjustment in some vulnerable OPCs (Chad, Yemen)

Current Context: Global Financial Crisis

Besides the oil price shock...

- Declining global asset values
  - Impacts on oil savings funds?
- Financing constraints
  - Past procyclicality of financing for OPCs (and EMCs)
- Sharp drops in domestic real estate and equity prices
- Impaired domestic financial institutions?
  - Excessive borrowing during the boom
- Lower remittances?
  - Gulf, Russia, Europe, US
- Impacts on non-oil exports?

...compound the adjustment process

Scope for Fiscal Stimulus?

- G-20 oil producers
  - Sizable fiscal stimulus in 2009 in Mexico (1.5 percent of GDP), Russia (1.7 percent), Saudi Arabia (3.3 percent)
- Other OPCs...*scope seems limited:*
  - Financing constraints
  - Limited safety nets
  - Sustainability, given medium-term price path
  - Recent expansion and carry-over of capital spending
  - Financial sector support? (Kazakhstan, Russia, Nigeria)
- *...all should aim to improve prioritization, quality of spending*

Looking forward? Adjustment in Medium-term Context

Given likely oil revenue trends and current fiscal positions...

...most OPCs need to adjust to ease pressures on reserves and domestic financing

Strategy:

- Clear and credible adjustment plan needed *(pace and composition will depend on country specifics)*
- Expenditure adjustments (in a medium-term context)
  - Wage restraint *(possibly reversal)*
  - Action on fuel pricing/subsidy regime
  - Strict prioritization of capital spending *(ongoing & new projects)*
- Efficiency-enhancing improvements to non-oil revenue regime
- Growth-enhancing (non-oil) structural reforms
- Exchange rate adjustment *(in some countries)*

...with support from the Bank and Fund

Thank you!