


# **Managing of resource revenues in oil-rich CAREC countries: Case Study of Azerbaijan**

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# Agenda

1. Intro to project
  2. Research questions
  3. Relevance to the CAREC region
  4. Specific objectives
  5. Literature
  6. Methodology
  7. What's been done
  8. Discussion
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# 1. INTRO TO PROJECT

Managing of resource revenues in oil-rich CAREC countries

by CESD



# Background

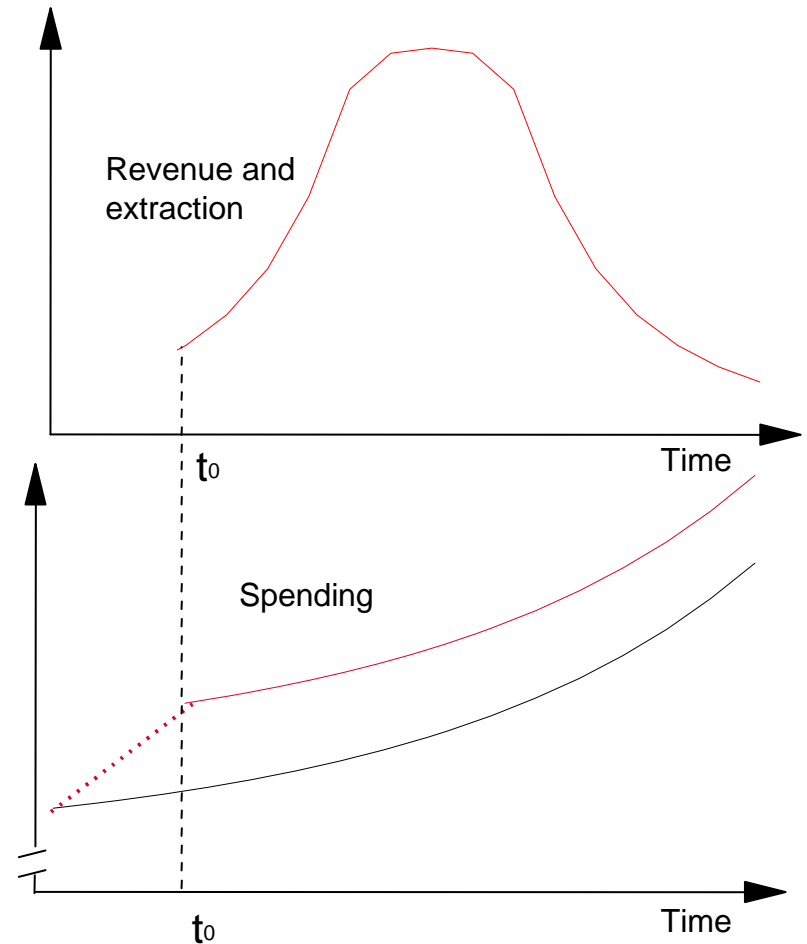
- ▶ CAREC regions
  - ▶ Countries rich with oil revenues
  - ▶ Short- and long-term effects on economy
  - ▶ Potential for economic overheating, and other Dutch disease ramifications
  - ▶ Importance of planning the management of oil revenues
  - ▶ Task of public sector: political institutions charged with economic tasks
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# Overall concept

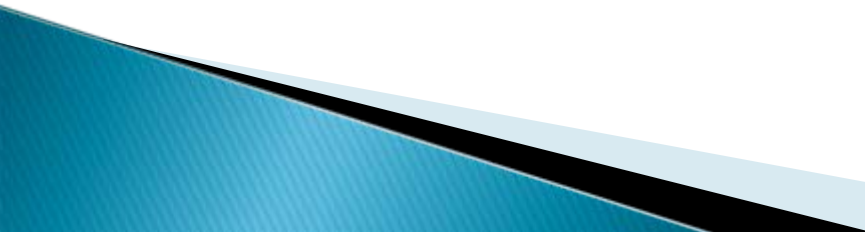
- ▶ *Oil extraction, as well as current revenues are: bell-shaped pattern*
- ▶ *Oil spending has to be: permanent increase*

## Conclusion:


Spending decisions to be separated from the extraction patterns/activities




# Case study -- Azerbaijan

- ▶ to be developed by CESD
  - ▶ implications for public budgeting and finance
  - ▶ revenue saving and sharing principles and models, permanent-income
  - ▶ 1. *Diagnostics*: oil fund, its role in overall public finance scheme
  - ▶ 2. *Analysis and implications*: macroeconomic, long-term public finance; transparency and portfolio strategies
  - ▶ 3. *Recommendations*: legislative, regulatory, institutional, governance and management aspects
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## 2. RESEARCH QUESTIONS


- ▶ How much oil revenue to be saved (invested) or spent
  - ▶ How and where the savings be placed
  - ▶ How much saving and stabilization functions each fund should assume
  - ▶ Different facets of revenue management looking at each country's macro context and institutional set up
  - ▶ Impact on regional integration in CAREC
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### 3. RELEVANCE TO THE CAREC REGION

- ▶ CAREC – long-term energy security and integration
  - ▶ Public sector governance and management
  - ▶ Diagnostics of institutional set up, macro-context and practices
  - ▶ Comparative study
  - ▶ Focus on oil-rich countries (Azerbaijan...)
  - ▶ Case study and implications for other CAREC countries
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# 4. SPECIFIC OBJECTIVES

- ▶ Macro and transparency implications
  - ▶ Scales, costs and benefits of domestic and foreign investment decisions
  - ▶ Circumstances and principles for domestic-foreign investment-saving
    - Diversification thru countries, businesses and currencies; hedging; corporate equities or T-bills and bonds...
  - ▶ Implications for the funds' asset management strategy
  - ▶ Legislative, regulatory and institutional implications
  - ▶ Analysis to draw conclusions and develop policy recommendations for the government of Azerbaijan
  - ▶ Outline best practices to be applied in other CAREC countries
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# 5. LITERATURE REVIEW

- The historical record of managing resource revenues has been extensively researched and extensively reviewed (e.g., van der Ploeg, 2007).
- Cross-country evidence suggests that countries can escape the resource curse (Sachs and Warner, 2007) and turn the windfall revenue into a boom if they have good institutions (Mehlum, Moene and Torvik, 2006), are open to international trade (Arezki and van der Ploeg, 2008), or have well-developed financial systems (van der Ploeg and Poelhekke, 2008).
- Macroeconomic effects of commodity booms in cross-country studies, Collier and Goderis (2007, 2008), including dynamics and global data from 1960 onwards; including increase in the price of commodity exports, non-resource output does indeed increase relative to what it would otherwise have been.

# 6. METHODOLOGY



# Data sources


- ▶ information bank has already been established by CESD
  - bulletins and reports of state bodies in AZ (Statcom, Oil fund...), official data on oil and non-oil sectors
  - reports of local and int'l organizations
  - ADB (Key Indicators, etc.),
  - Eastern Bloc Energy Ltd. (CIS & East. Europ. Energy Databook, etc.),
  - International Energy Agency (Energy Balances of Non-OECD Countries, Natural Gas Market Review, World Energy Outlook, World Energy Statistics, etc.),
  - IMF (Int'l Financial Statistics, Directions of Trade Statistics, etc.),
  - Oil and Gas Journal,
  - UNCTAD (Commodity Price Statistics, Handbook of Statistics, World Investment Report, etc.),
  - World Bank (Doing Business, World Development Indicators, etc.),
  - United Nations Economic Commission for Europe, UNECE Countries in Figures (comparative figures of CIS countries)

◦ ...

# Preliminary content

- ▶ **Preface**
- ▶ **Executive Summary**
- ▶ **Introduction**
- ▶ **Azerbaijan economy and oil revenues**
- ▶ **Anatomy of the Oil Inflows**
- ▶ **Is the economy ready for oil windfalls?**
- ▶ **Income tracking of State Oil Fund of Azerbaijan Republic**
- ▶ **Methodology**
- ▶ **Oil Savings and Reserve Management Frameworks**
- ▶ **International practices (Norway, Venezuela, Oman, Kuwait...)**
- ▶ **Macroeconomic cost of fiscal volatility**
- ▶ **Medium-term budgeting**
- ▶ **Long-run fiscal stance**
- ▶ **Benchmarking**
- ▶ **Permanent income**
- ▶ **Other models**
- ▶ **Oil price sensitivity and income uncertainty**
- ▶ **Evaluation of alternative models and adjustments**


# Content, cont'd

- ▶ **Fiscal rules, hedging and other strategy components**
  - ▶ **Rationale for funds**
  - ▶ **Possible functions of the funds**
  - ▶ **Budget or Fund**
  - ▶ **Saving or stabilization**
  - ▶ **How much risk**
  - ▶ **Management strategy for the fund**
  - ▶ **Saving or investments**
  - ▶ **Domestic investment and risks**
  - ▶ **Asset management practices**
  - ▶ **Institutional arrangements**
  - ▶ **Governance, Transparency, and Accountability**
  - ▶ **Policy Implications**
  - ▶ **Conclusion**
  - ▶ **References**
  - ▶ **Annexes**
- 

# Current Analytical Framework


- ▶ Permanent Income” Approach
  - Determine amount that can be spent forever
  - A useful attempt to impose fiscal discipline
  - Given oil production, assumed oil price profiles
- ▶ Risk is not considered

# Pitfalls


- ▶ “Dutch disease”
  - ▶ A lack of focus on the non-oil economy
  - ▶ **Poor governance and inefficient spending**
    - Resource wealth often associated with weak government institutions
    - Budget fragmentation and “fiscal gimmickry” may hamper spending efficiency
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# Three main functions:

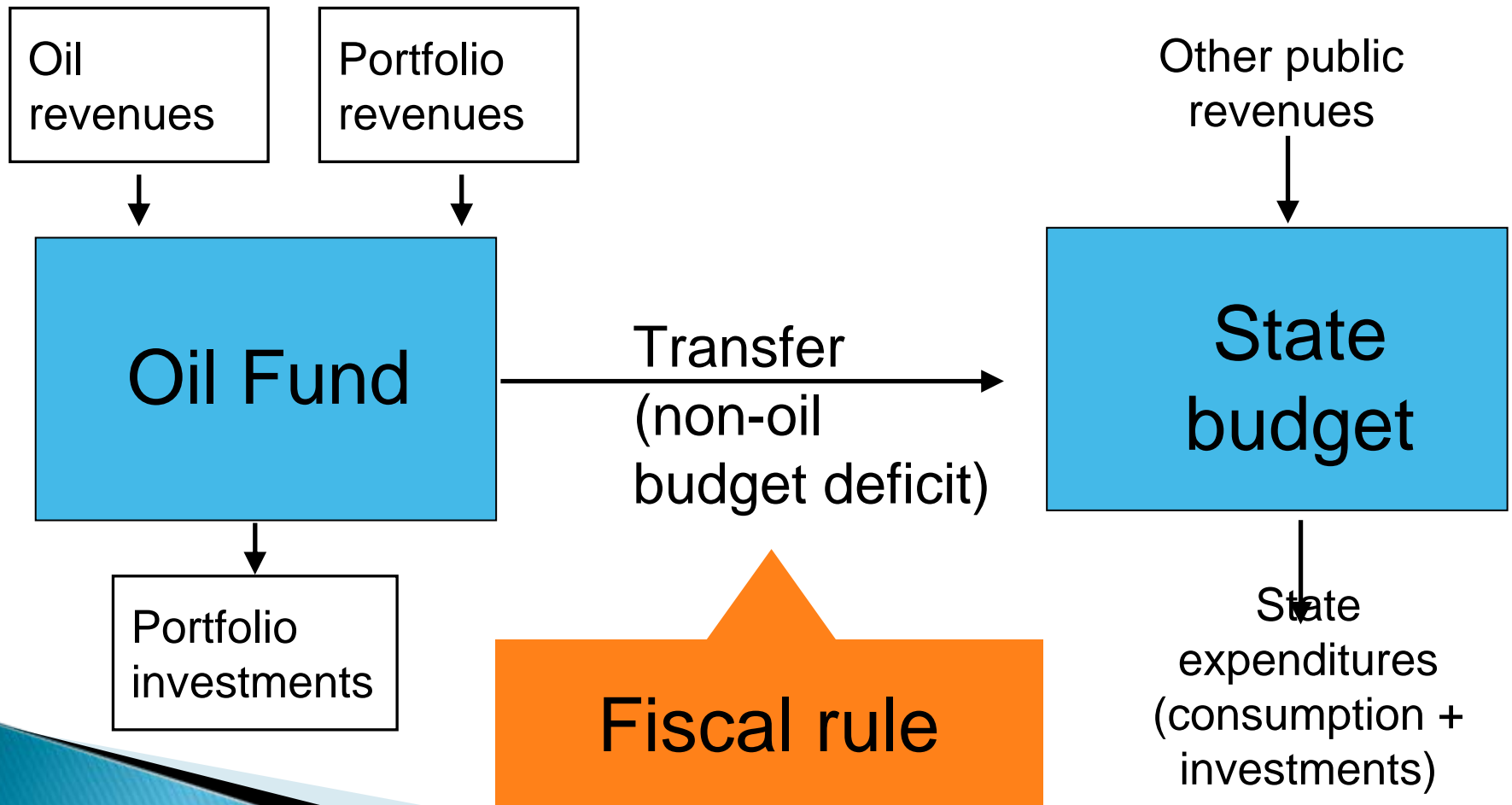
- ▶ Saving (e.g. Alaska Permanent Fund, Kuwait Reserve Fund for Future Generations)
  - ▶ Stabilization (Chile Copper Stabilization Fund, Venezuela Macroeconomic Stabilization Fund)
  - ▶ Financing (Kuwait General Reserve Fund, Norwegian State Pension Fund, Timor-Leste Petroleum Fund)
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# Stabilization funds


- ▶ Aim to reduce the impact of volatile revenue on the government and the economy.
  - ▶ Inflows and outflows are typically contingent on whether the petroleum revenue or price is “high” or “low,” compared to some historical average or pre-determined threshold.
  - ▶ The idea is that the fund would receive money from the budget when petroleum revenue is particularly strong and pay out to the budget when petroleum revenue is particularly weak.
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# 7. WHAT'S BEEN DONE

# Oil fund role and fiscal rule, macro concept



# How is risk managed in Azerbaijan?

- ▶ Demonstrated approach with respect to financial asset management is highly conservative
  - ▶ More liberal spending of oil revenues is inconsistent
  - ▶ Need to develop a consistent and disciplined approach to risk
    - Value at Risk Models are in common usage among Financial Risk Management Professionals
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# Public find -> accountability

- ▶ **Transparency:** public disclosure
  - Goals, regulations, reports, decisions, holdings
- ▶ **Governance and management**
  - Parliamentary control, CSO board
  - Clear lines of responsibility
  - Separation of ownership and management
  - Independent and external audits
  - Performance measurement
- ▶ **Institutional set up and incentives**
  - Holding the fund accountable and interested in growth
- ▶ **No duplication (waste)**
  - Shouldn't assume functions of state budget

Thank you

## 8. DISCUSSION



# CENTER FOR ECONOMIC AND SOCIAL DEVELOPMENT

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