

# **Managing Resource Rents: Lessons from Central Asia and Azerbaijan**

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# The Importance of Macroeconomic Stability, Savings and Diversification: Three Themes

## ***1. Macroeconomic Stability and Savings.***

- How have Central Asian resource rich nations maintained macroeconomic stability?

## ***2. The role of the State in the development of natural resources.***

- What has been the experience of the state taking significant equity positions in major mining or energy projects?

## ***3. Economic Diversification.***

- What policies have Central Asian countries pursued to promote diversification away from mineral or oil dependence?

# 1. Macroeconomic Stability and Savings.

- How have Central Asian resource-rich nations maintained macroeconomic stability, and what do they do to ensure that they can deal with the impacts of commodity price cycles on the national budget?

[Note that for oil and gas exporters judgments about success or failure are difficult because they have only experienced increasing revenues over the last decade --- until the past two months]

# Economic Issues

- Dutch Disease
  - $\uparrow$  export revenues  $\rightarrow$  ER appreciation  $\rightarrow$   
 $\downarrow$  competitiveness of other traded goods
- Volatility and public spending
  - a major issue in the 1970s oilboom  $\rightarrow$   
popularity of oil funds
- Present and future well-being
  - also addressed by sovereign wealth funds

First, look at the macropolicy challenge.

# Macroeconomic Policy

**Kazakhstan:** after 1999 had a *de facto* ER anchor

the ER in February 2006 = 130/\$, the same as end-May 1999.

since 2003 ↑ demand pressure from:

- large FDI-financed oil investments,
- fiscal and public sector expansion,
- a credit-fuelled private boom (partly funded by banks borrowing overseas on the assumption of a fixed ER)

The central bank prevented ER appreciation by accumulating forex reserves, including oil fund assets (>12 months of imports by the end of 2006),

# Assessment of Kazakhstan's Macroeconomic Policy

Avoiding ER appreciation was related to minimizing Dutch Disease effects

- the diversification policies (described later) would have been less successful if the ER had appreciated, making it harder for non-energy producers to compete with foreign producers

However, a fixed and undervalued ER → other problems

- e.g. undervaluing assets in Kazakhstan → unsustainable capital inflows

and correcting these problems → macroeconomic instability

# Kazakhstan's Banking Crisis

Excess demand + fixed ER → a banking crisis

in October 2007 Kazakh banks' international borrowings = \$12 - 40 billion

In November 2007

- the government provided support of around \$4 billion, targeted at construction projects in danger of being abandoned half-finished,
- the central bank raised the official refinancing rate, which had been unchanged at 9% since July 2006, to 11%.

Among the consequences have been an acceleration of **inflation**,

- fairly stable around 7% in 2000-5 rising to 9% in 2006.
- official 2007 change in the consumer price index was 18%,
  - and many consumers believe this is an understatement.

The government pumped \$4 billion into the economy in November 2007 -- the issue is not whether that was inflationary but by how much.

# Oil Funds etc.

Sovereign Wealth Funds (SWFs) can, and have, been used to address the three economic issues of

- Dutch Disease
- Volatility and public spending
- Present and future well-being

# Models for Oil Funds

Norway and Alaska often cited as model oil funds whose goal = save some of the benefits for future generations:

- plus some use of revenues for public budget (Norway) or redistribution to residents (Alaska)

Key feature = well-managed, transparent and democratic institutions to protect the interests of future generations

But note that:

1. Dutch Disease issues are not raised:

- Norway has shown little concern about economic diversification
- Alaska has a fixed ER

2. They are not used as stabilization funds

# Present and future well-being: Alaska

The Alaska Fund = a model built on a concept of individual ownership and intended to spur demand and consumption.

1. At least a quarter of all oil revenues received by the state must be invested permanently on behalf of the state's residents, transforming non-renewable oil wealth into a renewable source of wealth for future generations of Alaskans.
2. In 1980 the State Legislature created the Permanent Fund Dividend Program, to distribute a portion of the income each year to eligible Alaskans as a dividend payment: the 2008 dividend is \$3,269

# Present and future well-being: Norway

Norway's fund also converts petrodollars into stocks and bonds, but is controlled by the Ministry of Finance rather than being the subject of a constitutional amendment

1. The Fund invests oil revenues to ensure the equitable distribution of wealth across generations - essentially a pension fund.
2. instead of paying dividends, the Minister of Finance has the authority to use Fund assets for current government expenditures.

The Minister has exerted discretionary power in changing the rules about allowable assets (i.e. the shares of stocks and bonds and the need for ethical investing).

# Assessment of Oil Funds in Alaska and Norway

1. Despite the differences between the Alaskan and Norwegian funds, both have functioned well as consumption smoothing mechanisms:
  - exceptional oil price increases in the early and mid-2000s allowed Alaska to make larger dividend payments to citizens and allowed Norway to use the fund for social goals (eschewing revenue by ethical investing and transferring funds to the state budget for social programs).
2. In neither case is the fund involved in changing the economic structure
  - indirectly the funds may be influencing economic structure (by private investment of dividend in Alaska or by public policy financed by oil revenues in Norway), but this is not an explicit goal
3. Both funds have high levels of accountability, achieved in Alaska by transparency and voter activism and in Norway by an incorrupt representative government.

# Lessons from Alaska and Norway

The main lesson from the 1970s resource boom = governments of resource-rich countries spent too much without regard for future generations

- The Alaska and Norway funds = examples of protecting future generations' interests by well-managed funds

The key is good governance and accountability.  
What if they are lacking?

Moreover, other countries may be concerned about the Dutch Disease and diversification.

# Azerbaijan (SOFAZ)

Oil revenues accrue to the Oil Fund, which transfers a portion to the government budget and invests the remainder overseas to mitigate Dutch Disease effects:

1. in 2003 SOFAZ funds were used to finance resettlement and other assistance to people displaced by the Nagorno Karabakh conflict (\$24m), to contribute to Azerbaijan's share of the cost of the Baku-Tbilisi-Ceyhan pipeline (\$133m), and \$115m was transferred to the state budget for other purposes
2. the investment strategy has been fairly conservative (liquid fixed-income assets), but may become more aggressive and forward-looking as funds (and expertise) build up.

In July 2004 Azerbaijan became a pilot country for the Extractive Industries Transparency Initiative (EITI) = a positive signal about transparency and accountability, even though the EITI only relates to how revenues are collected, not how they are spent.

# Kazakhstan (NFRK)

The National Fund for the Republic of Kazakhstan established in August 2000 has a stabilization and a savings function:

1. Extra revenues are transferred to the NFRK when prices exceed reference prices for oil and some minerals.
  - the NFRK must keep at least a fifth of its assets in the stabilization portfolio, which must be invested in liquid foreign financial instruments.
2. The savings portfolio appears to be conservatively managed, but actual criteria are non-transparent.
  - the President has the authority to request special transfers from the NFRK to state or local budgets for purposes defined by the President, although to date no such transfers have occurred.

A sign of improved transparency = Kazakhstan became an EITI candidate country in 2007 - first EITI report published in January 2008.

# **SOFAZ and the NFRK Evaluation I**

## **Transparency and independence**

- Both were established by presidential decree rather than by legislation, leaving both funds subject to presidential discretion.
- The NFRK is generally considered less transparent than SOFAZ, due to the weaker independent oversight and greater discretionary power of the President
- Limits on media independence and civil society in both countries restrict the kinds of oversight existing in Alaska or Norway.

# **SOFAZ and the NFRK Evaluation II**

## **Lack of concern for poverty alleviation.**

- The Azeri fund has been used to help internally displaced persons, but neither fund has a mandate to address poverty.
- Indonesia in the 1970s shows the potential for such uses (invest in human capital)
  - but there are many other examples of windfalls being frittered away in supposedly productive current projects.

**Social returns on domestic investment may be high,  
but project evaluation must be good.**

# **SOFAZ and the NFRK Evaluation III**

## **How governments finance their budget.**

- In 2003-6 Azerbaijan borrowed abroad (about 4% of 2006 GDP) to finance a non-oil fiscal deficit, when SOFAZ funds were being invested internationally to fetch 3-4% in nominal dollar terms,
- Azerbaijan was using its oil windfall to finance public expenditure, including poverty alleviation through water and irrigation projects, but it was doing so in an inefficient, and to some extent non-transparent, way.
- By contrast Kazakhstan was paying off external debts to reduce future obligations.

**Good budget (and Fund) management matters!**

## **2. Managing the development of natural resources and the role of the State.**

1. Production Sharing Agreements (PSAs)
2. Experience with taking significant State Equity positions in major mining and energy projects

# Production Sharing Agreements

The dominant contractual form for exploiting oil and gas resources in the Caspian Basin and minerals elsewhere in Central Asia (such as the Kumtor goldmine in the Kyrgyz Republic) = PSAs

PSAs between foreign companies and the state reflect

- the need to draw on firm-specific technical expertise,
- high initial costs (and risks) to foreign companies exploring and developing a potential new mineral deposit,
- the right of the state to residual returns.

PSAs are front-loaded so that the foreign investor retrieves much of the pre-production costs before future revenues are shared in agreed proportions.

Under a PSA the state cedes some sovereign immunity by entering into a detailed contractual arrangement.

# Renegotiating PSAs

To supply the financial and human resources to develop resources, foreign companies need credible commitments that they will not be expropriated once resources are being profitably exploited  
– or at least an arrangement whereby they can recoup their investment and reduce the cost of expropriation.

The picture was further complicated in the post-Soviet space by:

1. the rapid increase in energy prices since the late 1990s
2. by the new independent states' negotiating inexperience.

Renegotiation was justified by (2), but was really driven (1)

--- or by a simple wish to renegotiate the contract in the host country's favour once exploitation was under way.

The danger for the host country is that any one-sided renegotiation of contracts might deter future foreign investment.

# PSAs in Kazakhstan

Concern in Kazakhstan since 1997 that PSAs gave too much to foreign partners at the expense of Kazakhstan.

- when such concerns were first voiced, foreign investors protested strongly
  - President Nazarbayev guaranteed that no existing PSAs would be amended without consensus.
- 1999: amendments to the Oil and Gas Law strengthened local content requirements
  - subsequent PSAs specified local sourcing elements.
- a growing tendency to favour domestic partners
  - the 2005 PSA Law mandated a minimum fifty percent participation of *Kazmunaigas*.

# Kazmunaigas

*Kazmunaigas* - created in November 2002 - a 100% state-owned vertically integrated company

- operations include exploration and production, transportation, oil refining, petrochemicals and marketing of oil and gas,
- *Kazmunaigas* is the government's negotiating arm in PSA contracts.
- *Kazmunaigas* supplies subsidised fuel to domestic markets and provides some social services, reflecting its close connection to government and role in policy implementation.

This role also includes increasing rent extraction for the government.

- in this *Kazmunaigas* resembles the Russian state-owned companies, *Gazprom* and *Rosneft*,
- although *Kazmunaigas* has acquired larger shares of energy projects in a straightforward manner by purchase or the transfer of state-held licences.

# Revising Contracts

In 2004 Kazakhstan began to revise the tax and other laws pertaining to PSAs.

The government also demanded a larger share for the national oil company, *Kazmunaigas*, in energy projects.

- A flashpoint = the Kashagan oilfield dispute
  - in mid-2007 development ran into technical difficulties, cost overruns and revised projections of when oil exports would begin.
  - dispute settled in January 2008: foreign participants agreed to reduce their shares in order to permit *Kazmunaigas*, to increase its share to 16.7% (the same as that of other lead shareholders).
- Has this discouraged future investment?

# State ownership

Good at maintaining output, but poor record of increasing output in Turkmenistan and Uzbekistan

- limited foreign involvement in energy sector

- Azerbaijan

- major oil companies provide technology

- SOCAR only becoming more proactive in 2007-8 – but seen as bloated and inefficient

- Kazakhstan

- KMG played a more prominent role than SOCAR

- Kyrgyz Republic

- foreign gold producer provided technology

# **(Tentative) Conclusions on PSAs and State Ownership**

- Foreign expertise needed to develop oil & gas in Caspian basin and gold in Kyrgyz Republic -- PSAs = instrument
  - absence of foreign companies associated with slower resource development in Turkmenistan
- Revising PSAs and increased role for state companies can increase domestic benefits in the short-run, but may deter future foreign investment –too early to tell

# 3. Economic Diversification.

- Import-substituting industrialization policies in Turkmenistan and Uzbekistan
  - connected to interventionist approach to commodity revenue fluctuations (eg strengthening forex controls by Uzbekistan 1996 Turkmenistan 1998)
- Unsuccessful because ISI enterprises were inefficient,
  - but policies have been difficult to reverse despite policy changes in Uzbekistan since 2003, and Turkmenistan in 2008.

# Kazakhstan

## 2030 plans

- the Agriculture and Food Program
- industrial policy
  - promoting clusters
- The benefits of trial and error (reform Chinese style)
- Investing in human capital
- Improving the business environment
  - create a good playing field and let the best team win

# Conclusions and Lessons I

- Macroeconomic management is a challenge
  - Fighting Dutch Disease by limiting ER change can lead to financial sector problems
  - Fighting Dutch Disease by investing abroad may divert investment from domestic projects with high social returns
- SWFs can insulate revenues from immediate demands,
  - reducing negative impacts of volatility on public spending
  - balancing present and future well-being
- but need to be transparent and well-managed

# Conclusions and Lessons II

Host countries should

- negotiate their best deal, but
- recognize foreign investors' concerns about time consistency and commitment to contracts

State-owned resource companies can

- provide an eye on PSAs, and localize rents
- but can also become bloated and inefficient

Important issues concern the endowment of trained domestic personnel (and the ability to develop such human resources) as well as accountability

# Conclusions and Lessons III

- The desirability of economic diversification is unclear (eg. ignored by Norway)
- Little evidence of oil funds (or other statist policies of “picking winners”) being good vehicles
  - investing in human capital or infrastructure, and improving conditions for doing business seem better approaches
    - create a good playing field and let the best team win

# A Non-Conclusion

- There is no evidence from Central Asia of successful stabilization of commodity earnings or of the flow into the public budget
  - in Kazakhstan the reference prices proved too low (\$19 for oil), indicating the difficulty of predicting the long-run equilibrium price.
- A well-managed Fund can save part of a windfall for future generations,
  - but do not expect it to smooth out revenues in the short- or medium-term.