



## **FIVE RECOMMENDATIONS FOR MANAGING NATURAL RESOURCE REVENUE IN TIMES OF CRISIS<sup>1</sup>**

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For most of this decade, the governments, extractive companies and civil society groups working to strengthen the governance of natural resource revenues have lived in "times of plenty". The World Bank estimates that real commodity prices in local currency units increased by between 75 and 150 percent from 2000 to 2008. Budget surplus averages in oil exporting country grew from 0.6 to 7.7 percent of GDP from 2001 to 2007. In developing countries that export oil, official foreign reserves doubled from \$36 to \$70 billion between 2000 and 2008. Mineral producing countries experienced a similar boom over the same period, with metal prices rising by over 180 percent.

Until recently, the policy debate has focused on the best ways to manage the resource boom and decrease volatility risks, from smoothing expenditures and diversifying long-term sources of growth, to reviewing extractive contracts and increasing transparency across the extractive value chain.

The dramatic change in the economic and political environment raises new challenges for resource revenue management in developing countries. Global financial turmoil has triggered a sharp decline in prices. Commodity indices have lost 50 percent of their value since their peak in July 2008 and WTI crude oil futures have fallen from \$147/barrel to less than \$50 over the same period.

What are the implications of the global turmoil for the governance of oil, gas and mineral revenues in developing countries? Volatility in commodity prices is affecting resource-dependent countries through a variety of channels which must be assessed on a case-by case basis. The wide swings in commodity prices will impact each country differently depending on its particular resource endowments. This paper provides a brief description of the channels through which the global financial turmoil can impact the economic and political conditions of resource abundant countries, offers recommendations for the effective, equitable and transparent management of extractive resource revenues.

### **I. The channels of impact**

The current global financial turmoil can affect developing countries through four main channels.

#### *Financial markets*

Stock markets in developing and emerging economies feel a negative shock because of financial contagion from the ailing stock markets of developed countries. The financial markets of the largest

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emerging economies such as Russia, India and Brazil have substantially plummeted over the past few months. The Nigerian stock exchange lost 45.9 percent of its value over the last year; the Johannesburg Stock exchange declined by 25.7 percent over the same period (African Development Bank, 2009).

#### *Foreign Direct Investment and Borrowing*

According to the Institute of the International Finance, net private capital inflows to emerging economies declined by 30 percent in 2008, compared to 2007. The credit crunch directly affects investment in oil, gas and mineral projects. In Russia, Gazprom and Lukoil have indicated that the financial crisis is jeopardizing their ability to refinance debts and may affect their cash flow forecasts and investment plans. Total has noted that its Canada oil sands projects require an oil price close to \$90 a barrel to develop while still addressing environmental impact. The massive capital requirement for the development of Petrobras subsalt fields (estimated at \$500 billion) will result in important delays as prices continue to fall and access to credit remains scarce. The credit crunch has also postponed the proposed Xstrata takeover of a mining conglomerate in South Africa.

#### *Trade and commodity prices*

Demand for raw materials and minerals, the primary export commodities of developing countries, has declined due to the economic slowdown in developed countries. Since commodity exports are a major source of economic growth, foreign exchange earnings and fiscal revenues in resource rich countries, are all experiencing a significant fall in government revenues. Moreover, the decline in demand further reduces commodities prices and creates even larger budgetary shortfalls.

#### *Fiscal squeeze*

The decline in revenues is further compounded by the rise in expenditures resulting from the need to support financial institutions and to service debt. A large number of extractive producers are now being forced to revisit and dramatically cut their 2009 budgets in light of declines in pricing and demand. In Iraq, the government has cut its budget twice and it now stands at \$53.7 billion, down from the original planned \$79 billion for 2009 and from an interim cut to \$68.6 billion, according to the Finance Ministry. The government of Nigeria also significantly reduced its oil price benchmark for fiscal year 2009, from \$62.5 to \$45. In January, the Russian government adjusted its oil price forecasts from \$95 to \$41 per barrel. Russia is also planning to cut back some 2009 investment programs to reduce the expected deficit. Kazakhstan decreased its oil price reference from \$60 to \$40 for 2009 and is considering further adjustments.

## **II. How vulnerable are resource-dependent countries?**

A recent report from the World Bank on [Global Economic Prospects for 2009](#) finds that commodity-producing countries have managed the revenue windfall better than in previous booms. Fiscal spending has been more prudent which resulted in more modest exchange rate appreciation. While government expenditure has increased in real terms over the last boom, it has decreased by about 5 percent as a share of GDP. Corruption among commodity exporters also appears to have improved compared to diversified exporters.

The vulnerability of oil, gas and mining producers in developing countries to the current crisis depends on the soundness of their macroeconomic situation and their degree of integration with the global financial system. Resource-rich countries that have accumulated windfall revenues since the start of the resource boom are better prepared to respond to the crisis. These countries had prudent fiscal policies and put away a significant share of the windfall in funds that can now help cushion the adverse effects of the crisis. Qatar and Kuwait have suggested that money from sovereign wealth funds might be used to help stabilize domestic markets. Russia passed legislation allowing the National Welfare Fund to invest in

domestic securities. Kazakhstan has already spent \$4 billion dollars in 2008 to support its ailing banking sector and is expected to spend another \$17.4 billion dollars in 2009-2010 to revive the economy. Kazakhstan also devalued the tenge by almost 20 percent as a result of the fall in oil prices and the sharp depreciation of the Russian rouble. However, if industrial countries are unable to contain the crisis within a relatively short period of time, the reserves and savings funds in resource abundant countries will quickly erode.

Other resource-rich countries are unfortunately less prepared and have been caught empty handed due to liberal public spending inadequate saving policies during the recent boom. The World Bank has recently suggested that newer producers are more vulnerable to the commodity price shock and the financial crisis. In countries with newly found resource wealth, fiscal spending correlates closely with export revenues and currencies have appreciated in real terms (against the U.S. dollar) by an average 43 percent between 2001 and 2007. The list of new entrants—defined as countries dependent on oil that began production after 1985 or were established as countries after 1985—includes a number of oil-producing countries such as Azerbaijan, Chad, Equatorial Guinea, Kazakhstan, Sudan and the Republic of Yemen.

#### **Recommendation 1: Support the Newcomers**

**The asymmetries between recent and older producers call for renewed support for countries with a shorter history of resource extraction and a weaker capacity to manage related revenues. At the international level, multilateral agencies, bilateral donors, the Extractive Industries Transparency Initiative (EITI) Secretariat and non-governmental organizations should coordinate their assistance to "new" producing countries. At the national level, governments and civil society need to manage expectations and build their own capacity to help maximize development impact in countries with nascent extractive industries.**

### **III. The implications of the crisis for the governance of oil, gas and mining revenues**

The commodity price shock and the global economic crisis provide important lessons for natural resource revenue management. The recent boom has been the largest and the longest since 1900. The exceptional nature of this period of abundance may have distracted commodity exporting countries from vulnerabilities in their economic structure. The fall in commodity prices is a painful reminder of the distinct challenges for exporting countries. The current adjustment may thus be a return to historical norms rather than an aberration in the steady increase in natural resource prices.

#### *A return to volatility*

The resource boom created a false sense of confidence that commodity resource prices were experiencing a "super-cycle"<sup>3</sup> with no foreseeable end. But the crash in commodity prices has brought volatility to center stage in the policy debate for resource-dependent countries. In Peru, the commodity price drop has directly affected sub-national governments that receive large sums through natural resource revenues fiscal transfers. Oil producing regions such as Piura are already being affected, while mineral producing regions are more likely to suffer negative impacts in the second part of 2009 and 2010 due to the structure of the fiscal transfer system.

High commodity prices also distracted a number of governments from the finite nature of oil, gas and minerals and the need to diversify their economies in order to sustain economic and human development. The current crisis underscores the reality that economic diversification is the best long-

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<sup>3</sup> See for instance: [www.stockinterview.com/News/11162006/Fuller-super-cycle.html](http://www.stockinterview.com/News/11162006/Fuller-super-cycle.html)

term solution to commodity price volatility. The crisis may delay diversification efforts, however, since non-resource sectors will be burdened with new taxes and the demand for manufacturing goods will decline. In Indonesia the diversification of the economy implies that falling international oil prices will improve the sustainability of the budget - unless the government decides to reduce domestic fuel prices. Because of falling international oil prices the government spent less on fuel subsidies and posted a lower than expected budget deficit of 0.1 percent of GDP in 2008. Yet, the plunge in oil and gas prices will decrease central government transfers to oil and gas producing regions placing some pressure on sub-national budgets.

Sound fiscal policies and institutions are essential to an effective short-term response to the crisis and to sustainable economic development. Countries that have saved a significant share of the windfall to smooth expenditures are better placed to use reserves as a counter-cyclical instrument. Accumulated reserves can be deployed to limit the fiscal squeeze and to rescue financial systems. Prudent fiscal management in resource-dependent countries also requires greater attention to non-resource fiscal balance to measure countries' vulnerability to changes in commodity prices. Medium-term expenditure frameworks can also reinforce macroeconomic stability and increase policy space by laying out the trade-offs and implications of different natural resource price and economic scenarios.

The effectiveness of sovereign wealth funds in responding to natural resource revenue challenges is uncertain. The demand for advice on savings instruments will be limited as natural resources windfalls dwindle. Sovereign wealth funds can provide safeguards against volatility and smooth out government expenditures, by ensuring that they are driven by medium-term objectives rather than by revenue availability. However sovereign wealth funds have also been hit hard by dramatic stock market declines. Norway's Government Pension Fund Global is down 15 percent in 2008 despite record inflows. The accumulation of large revenue can also create financial and real estate bubbles that can collapse rapidly without financing any real economic diversification.

The banking crisis in Kazakhstan illustrates this danger. Stabilization funds can help to smooth expenditures, but they have limited effectiveness as a response to systemic and economy-wide shocks. Moreover, early observations indicate that excessive savings of the oil revenues have jeopardized the banking sector in some countries. Buoyed by the favorable sovereign ratings due to growing oil fund assets, banks in some countries borrowed heavily from the international credit market to support the construction and real estate sectors. Russia and Kazakhstan, among others, have had to dip deep into their oil funds to bail out banks and non-bank borrowers with large foreign currency obligations. Kazakhstan's sovereign wealth fund recently funded the nationalization of BTA the country's first bank, buying 78.14 percent of shares for a total of \$2.06 billion. In Russia, Vladimir Putin announced that the three main state-controlled banks (VTB, VEB and Sberbank) would receive up to \$28 billion. While further research is warranted, there is increasing evidence that an accumulation of large assets in natural resource funds creates a moral hazard and hampers critical investment in economic diversification.

#### **Recommendation 2: Increase Diversification to Reduce Dependency**

**Volatility in commodity prices underscores the need for long-term economic diversification in low-income resource-dependent countries. Prudent fiscal policies driven by medium and long-term expenditure frameworks—and not by revenue availability—are critical to mitigate vulnerability to erratic prices. Improved legislative oversight and civil society monitoring and advocacy are required to avoid boom-bust cycles, sustain economic growth, and reduce dependency on natural resource revenues**

### *Spending scarce capital well*

Efficient spending of resource windfalls has been a central policy objective of the resource boom period. The fall in commodity prices and the financial crisis reinforce the need to "spend wisely" as access to capital becomes scarcer and resource windfalls shrink. Yet the downturn also calls for counter-cyclical policies geared toward the economic and social sectors affected by the crisis.

While resource-rich countries may seem better positioned to handle the credit crunch than resource-poor developing countries with smaller cushions and lower revenue bases, their fiscal systems still lack the capacity to accommodate the recent dramatic fall in primary export prices. A number of resource-rich countries will be forced to abandon or delay large infrastructure and social projects, and draw on substantial savings from their resource funds. In countries already producing oil, gas or minerals, a significant portion of windfall revenues will likely be spent to contain the negative effect of the crisis, making less funding available for long-term development.

Resource-dependent countries also need to maintain social equity and mitigate the effects of the crisis on the most vulnerable areas of society. Governments face a significant challenge balancing protection for their banking and financial sectors with fiscal measures aimed at stimulating the real economy and protecting the poor. Nonrenewable natural resources generate an exogenous flow of revenue that has a significant impact on the budget process, as the specific terms that govern resource revenues can often lead to inefficient and inequitable spending allocations. Low-income resource-dependent countries may also attempt to compensate for losses in commodity revenue by increasing indirect taxation with regressive tax reforms that inevitably increase the social cost of the crisis on the poor.

The redistribution of natural resource revenues across levels of government should also be considered in the implications of the crisis. At the country level, the fall in commodity crisis affects local regions differently. Maintaining equity across regions and avoiding crisis in producing regions are critical to mitigating commodity price shock. In Peru, a number of producing regions and municipalities relying on natural resource revenue transfers face significant fiscal adjustment if the central government does not develop compensatory mechanisms.

### **Recommendation 3: Reinvest Revenues Domestically to Build the Non-Resource Economy**

**Natural resource revenues should be used first and foremost for domestic investment in physical, social and human assets, not for consumption or current spending. Resource-dependent countries should enhance spending efficiency in response to reduced access to capital. While the financial crisis makes this choice harder, governments from low-income countries need to prioritize the adequate provisioning of key public goods and social protections for the most vulnerable sectors of society. Parliamentarians, civil society and the media need to know and assess the policy options and trade-offs necessary to foster sustainable economic growth and human development.**

### *Taking a long view on contracts review and negotiations*

The financial crisis and the drop in commodity prices threaten the ability of governments to capture a larger share of their natural resources windfalls. The recent push for contract and policy reviews in Africa and elsewhere has been driven by high commodity prices and the recognition that historically legal and fiscal frameworks have left countries with an insufficient share of their own windfalls. The urgency of this push for more equitable contracts is likely to subside as all parties wait to see whether or when the market will turn around.

Zambia's decision to abolish the 25 percent windfall tax it established less than one year ago marks a significant concession to the concerns voiced by mining companies, and the suspension of a highly

publicized and sweeping reform to the nation's minerals fiscal regime. But it is important to note that these latest revisions do not signal a complete reversal of the improvements made during 2008. The baseline profits tax, which rose from 25 percent to 30 percent remains at the higher level, royalties have been increased five-fold, and the variable tax—originally structured as a backstop to the windfall tax—will now be generally applied when the profitability threshold is reached.

While several of the provisions recently proposed will affect companies' fiscal burdens almost immediately, the headline change—the elimination of the Windfall Tax—will mean little in the short term since copper prices would have needed to rise by 67 percent, or about \$1 per pound, for the tax to come into effect.

The case of Zambia will surely serve as a warning to other countries now embarking on similar reform efforts. For countries that may not have acted quickly enough to implement changes—such as Sierra Leone, Guinea and Tanzania in Africa—the current situation may reduce both the immediate political and economic incentives to act, as well as the leverage available for any negotiations.

#### **Recommendation 4: Do Not Give Away the Store for Short-Term Gains**

**Governments considering or engaged in adjusting their financial or contractual regimes need to preserve their ability to capture any significant upside when and if commodity prices rebound. Targeted relief from fixed cost elements may be appropriate to reduce current operating expenses when that is necessary to keep operations going. However, the Extractive Sector relies on long-term contracts and long-term investment profitability assessments, not short-term prices fluctuations. Therefore resource-dependent countries need to take a long view on extractive industries investments to avoid damaging their revenue prospects. At the international level, governments need to increase coordination and avoid entering into a race to the bottom that would cause all to lose revenues.**

#### *The need for greater transparency*

Extractive resources are public assets, and decisions about their exploitation and use should be subject to public oversight. The fall in commodity prices and the global financial turmoil underscore the need for greater transparency in the extractive sector. Where once investors competed to pour money into resource rich countries and extractive companies, countries and companies will now need to compete fiercely to attract capital. If extractive industries companies and producing governments lower their standards, they will only attract short-sighted and speculative investors. Access to reliable and comprehensive information will provide a competitive edge to low-income producing countries striving for sustainable foreign direct investment.

Financial regulators will demand more disclosure from governments and companies that want to raise funds in their markets. Ongoing initiatives to increase accountability standards in the extractive sector's finances and operations with the International Financial Institutions, the International Accounting Standards Board (IASB) and the Extractive Industries Transparency Disclosure (EITD) Bill in the U.S. can advance this agenda. More risk averse investors will also require greater transparency and official guarantees from organizations such as the Overseas Private Investment Corporation (OPIC). For instance President Hugo Chavez's attempt to attract foreign investors to address Petróleos de Venezuela's (PDVSA) credit crunch and advance its political agenda offers an opportunity for demanding greater transparency in oil revenue management<sup>4</sup>.

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<sup>4</sup> See: [www.nytimes.com/2009/01/15/world/americas/15venez.html](http://www.nytimes.com/2009/01/15/world/americas/15venez.html)

While no policy instrument offers perfect protection against the effects of natural resource price volatility, transparency is critical to making fiscal institutions effective. New results from the Open Budget Index 2008<sup>5</sup> and Revenue Watch research<sup>6</sup> confirm a widespread lack of budget transparency in oil-producing countries. Public discussion of policy options is critical to ensuring that resource revenues are used to foster broad-based and sustainable economic growth. When prices drop, budget opacity hinders public discussion of available policy responses to the fiscal squeeze, often resulting in cuts in social programs and public investment that can undermine poverty reduction efforts. Implementing the Extractive Industries Transparency Initiative (EITI) to raise the level public oversight and accountability on resource revenues accruing to the budget is an important instrument to foster transparency in resource-dependent countries.

**Recommendation 5: Transparency Can Mitigate the Effects of the Fiscal Crisis and Help Secure Sustainable Development**

**Governments and investors must fully recognize that the lack of transparency is one underlying reason for the financial crisis. The promotion of transparency across the extractive industries value chain—in producing and consuming countries alike—is paramount to effectively address the current economic turmoil and the particular challenges of natural resource revenue management. Greater transparency reduces information asymmetries and opportunities for corruption and enables proper public debate about the allocation of increasingly scarce resources. With a commitment to implement the EITI and expand its scope beyond revenues to include contract and expenditure transparency, governments, companies and the entire extractive industries sector can begin immediately to mitigate the costs of inaction and the guard against the dangers of rogue capitalism.**

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<sup>5</sup> The Open Budget Index 2008 is available at: [www.openbudgetindex.org](http://www.openbudgetindex.org)

<sup>6</sup> Revenue Watch Policy Brief on Resource Dependence and Budget Transparency is accessible at:  
[www.revenuewatch.org/images/RWI\\_resources\\_OBI\\_2008.pdf](http://www.revenuewatch.org/images/RWI_resources_OBI_2008.pdf)