Economic and Financial Review

Volume 41 | Number 1 Article 4

3-31-2003

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Recommended Citation
Omanukwue, P.N. (2003). What goes up by (S. Barnet and R. Ossowski, Finance and Development: Vol. 40, No. 1 March 2003): a review. Economic and Financial Review, 41(1), 160-166.

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"WHAT GOES UP..." BY S. BARNETT & R. OSSOWSKI, FINANCE AND DEVELOPMENT, VOL 40, NO 1 MARCH 2003

REVIEWED BY P.N. OMANUKWUE

INTRODUCTION

The article established the need for oil producing countries to manage their oil resources, not solely because of the volatility of oil prices and uncertainty surrounding the derivation of oil revenue, but also because of the need to plan for a time when the oil would run out, considering the fact that oil is a non-renewable form of energy. While recognizing that oil producing countries differ in their size of oil reserves, ownership and taxation structure in the oil sector, maturity of the oil industry, relative importance of oil to the economy as well as the financial position of government, emphasis that fiscal policy decisions are affected by these differences are important points to consider because of the short and long run implications for fiscal policy. The objective of the article therefore is to suggest ways by which fiscal policy can be assessed in Oil producing countries as most oil producing countries were on the verge of experiencing fiscal crisis, if their oil resources are not properly managed. Thus, the need to pursue fiscal strategies aimed at streamlining procyclical fiscal responses to volatile oil prices as well as reducing the non-oil fiscal deficits over time was advocated.

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SUMMARY OF THE PAPER

The study identified uncertainties about the size of oil reserves, cost of extracting oil and the future path of oil prices as some of the factors that pose long run challenges for fiscal policy. Accordingly, one of the functions of government is to allocate resources (government wealth, oil inclusive) equitably and efficiently. How to do this however, poses a challenge to fiscal policy. A framework for targeting a fiscal policy that preserves the wealth of the economy, such that resources are allocated from a permanent source of income or one that at least offers an implicit return on government wealth was suggested. In assessing the fiscal stance from a long run perspective, several principles were posited. Firstly, there is a need to differentiate between oil and non-oil balance of an oil producing country, and focus on the non-oil balance and relate it to government wealth. This is primarily because the non-oil balance (surplus/deficit) is a good indicator for measuring the direction and sustainability of the fiscal policy. Hence, in a long run perspective, the aim of government is therefore to choose a non-oil deficit that is consistent with fiscal sustainability and determined by government, rather than the flow of oil revenue. Secondly, while condemning a strategy of drawing down all of a country's assets as such a measure will force the government to go borrowing, leading to debt dynamics, it was stated that as a means of financing the non-oil deficits, sufficient assets should be accumulated, such that the return on them can sustain the deficit, once oil production ceases.

In discussing the paradigm surrounding the targeting of non-oil deficit, the "Bird in hand rule" was examined. As the name implies, it refers to a situation where spending decisions are based on only assets at hand. A major advantage of this rule is that it provides an insight to the

potential of a shock reducing the value of whatever possession a nation might have. An example is the possibility of technological advances providing alternative sources of fuel that are more efficient and cost effective, such that the value of oil is reduced to a barest minimum. This rule was however criticized on the grounds that it assumes that there would be no future oil revenues. Hence, it was suggested that the optimal size of the primary non-oil fiscal balance should be greater than that implied by the "Bird in hand rule" but smaller than that of a permanent income framework which excludes precautionary savings considerations.

The short run perspective results from the volatility and unpredictability of oil prices. Thus, a reliance on oil revenue, especially as a large percentage of total revenue, would lead to volatility in fiscal cash flows, volatile expenditure, render public finances vulnerable to an external variable that is beyond the control of policy makers, make budgetary planning and short run fiscal management as well as the efficient use of public resources difficult. This was buttressed with evidence from Venezuela (an oil producing country) for the period 1996,1998 and 2000, when oil revenue, as a percent of GDP, accruing to public sector was 27, 12.5 and 22.5 percent respectively. The macroeconomic costs and implications that arise from the above are numerous. Some of them include a reallocation of resources to accommodate changes in demand and relative prices, reduced quality and efficiency of government expenditure, exchange rate volatility as well as increased risks for investors in the non-oil sector. Therefore, there is a great need to smoothen the path of government expenditure in the light of oil price fluctuations.

In all, an oil producing country with a strong fiscal and financial position is more likely to absorb cash flow shocks that arise from

fluctuations in oil prices. This, they can do through a mix of adjustment and financing. By doing so, the government can pursue short run fiscal strategies that do not lead to fiscal instability as well as insulate the domestic economy from oil revenue fluctuations. The case of Norway was also cited. In this regard, countries with a history of prudent fiscal policy and the existence of huge financial assets or low levels of public debt have also aided an orderly mix of adjustment and financing during short run oil price downturns, leading to macroeconomic stability and reasonable growth rates even in an unfavourable oil market.

However, most oil producing countries experience persistent fiscal deficits, which basically arise from their inability to rein in expenditure when oil prices rise, with the results that during oil price downturn, it becomes terribly difficult to reduce expenditures, most especially as they belief the downturn will be short-lived. These persistent deficits have led to both domestic and external borrowing, with its resultant effects of crowding out private sector investment, high interests on loans, as well as inducing inflationary pressures. The long run effect of accumulated fiscal imbalances, monetary disequlibria and inflation has most often than not led to a suspension or abandonment of investment projects. For countries that are unable to accommodate oil revenue fluctuations as a result of financial constraints, the authors suggest a strategy of eliminating expansionary fiscal policy biases as well as critically targeting prudent non-oil fiscal balances. Such a strategy they posit would improve the creditworthiness of a nation.

Though the authors did not profer any quantitative conclusions on the desirable level of non-oil deficit, mainly because of the varying differences associated with oil producing countries, they, nevertheless advocated some

general principles pertinent for the formulation and assessing fiscal policy in oil producing countries, some of which include:

- Government should endeavour to accumulate substantial financial assets during the era of oil production as a means of sustaining fiscal policy in the post oil period

- There should be a decomposition of the overall balance into oil and non-oil balance in order to understand the fiscal policy developments as well as ascertain the macroeconomic impact of fiscal policy,

- The non oil balance, especially expenditure, should be adjusted gradually.

COMMENTS

The study is very informative and expansive as it sheds more light on the implications of an enormous dependence on oil revenue for the implementation of government's policies and projects. The need to disaggregate the fiscal balance into oil and non-oil balance is convincingly argued. The study is therefore useful to policy advisers as well as policy administrators, as it profers apt answers to specific questions. In many aspects, the authors' database was sparse, but their deductions are incontrovertible. A major weakness of the paper was the inability of the author to profer an estimate on the desirable level of non-oil deficit. In Nigeria, the practice of "spending it all" during rising oil prices makes her totally vulnerable to any downturn in oil prices. Such expansionary fiscal policies jeopardize the effectiveness of monetary policy, as the large and volatile movements in oil revenue are a source of excess system liquidity. There is also the need to address the boom-burst cycle of our fiscal

operations as the dependence of Nigeria on an unpredictable oil revenue to finance its capital expenditure has usually resulted to unsustainable budget deficits during periods of revenue burst. This is because, once the funds have been budgeted based on expected oil income, it is usually difficult to reduce the level of capital expenditure from its peak, in the face of dwindling revenue (ratchet effect), thus leading to borrowing from the Central Bank to finance such expenditure. The destabilizing effect of such deficit financing on macroeconomic indicators such as the inflation rate and exchange rate cannot be underestimated. In order to eliminate such procyclical fiscal policy, the establishment of a stabilization fund is recommended, such that when there is a windfall, the excess is put into the fund and expended when there is a fall in oil revenue. As a complement to this strategy, the use of hedging instruments can be adopted. Government should also give more priority to efficient and productive ventures, such as economic and social services as doing otherwise reduces resources available for future public investment and expands the deficit position of government.

As a long-term strategy, there is the need to focus on a non-oil primary balance, that excludes oil related revenue and spending such as NNPC cash calls, etc. In other words, Government should target a non-oil balance as a percent of non-oil GDP. This would ensure that the expenditure pattern is not affected by the volatility of oil prices. Also, the Fiscal Responsibility Act should be passed into law and implemented accordingly, as it helps to stabilize expenditure. Nigeria should have learnt its lessons from the oil crises of the 1980s. It is my opinion that with the increase in oil prices in recent times, efforts should be made to be prudent in fiscal matters, as well as increase government savings, via accumulation of financial assets so as to be on guard against exigencies. There is also the need for

government to be transparent and accountable when dealing with public funds. Also, if Nigeria's oil wealth is properly managed, it offers the country the luxury of sustaining a primary non-oil deficit. In conclusion, it is now evident that even an oil producing country with the largest oil reserve in the world cannot sustain its fiscal policy stance, in the face of volatile prices particularly countries with a long history of unproductive public expenditure.