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# Managing oil price risks in developing countries: a review

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# Managing Oil Price Risk in Developing Countries - Article Review*

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## I. Introduction

The economic performance of oil-exporting countries has generally been poor compared with those of oil consuming nations in spite of the huge revenue that accrued to them since 1973 when oil prices began to rise. This could partly be attributed to the way oil price shocks were managed by these countries. To manage government revenues that are dependent on highly volatile oil prices, the paper advocates a number of strategies that would assist in the management of oil exporting countries' revenue profiles for economic development. This review will, therefore, present a summary of the paper, evaluate the content by providing appropriate comments and draw some concluding remarks.

### *Summary of the Paper*

The paper on "managing oil price risk in developing countries" surveyed the strategies of managing revenues of oil exporting developing countries, particularly, through optimal savings and investment strategy. The paper noted the fact that if a country's revenue was generated from a commodity with volatile price, implementing an investment plan smoothly becomes much more challenging over time. On the other hand, with savings and stabilization funds, these allow a country to smoothen out investment expenditure and, thus, increase efficiency of investment by minimizing adjustment costs. The authors opined that stabilization or savings fund eliminates the effects of oil price fluctuation if oil volatility is temporary. This is because most of the volatility represents temporary changes, thus the value of oil revenue is not substantially affected by the monthly changes in oil prices. But in the case where oil

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**World Bank Research Observer 2004, No. 1 Vol.19, by Julia Devin and Sheridan Titman*

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volatility is permanent, a savings or stabilization fund would not be sufficient to offset the negative effect of fluctuations in oil prices on investment.

Consequently, the authors proposed the use of market-based financial instruments as the best-solution for dealing with oil price volatility. These financial instruments include "swaps", "futures" and "options" which "lock in" a known price for a given period, thereby, eliminating price uncertainty. Rather than self-insuring strategies through stabilization or savings fund, market-based financial instruments allow a country to transfer commodity price risk to the market.

In practice, the authors affirmed that governments of only few developing countries use financial (hedging) instruments to manage oil price risk. This is as a result of status quo problem, where government fears the possibility that the country may end up worse off as a result of the risk management decisions and also the problem of coordination failure arising from lack of professional expertise in coordinating between seller and buyer at the international financial markets. To address these problems of status quo and coordination failure, the authors suggested the need to educate government officials on the use of market-based instruments and encourage the involvement of investment banks to develop the counter-party side of providing the expertise at the financial markets for oil price exposure.

In conclusion, the authors opined that to deal effectively with oil price volatility, greater efforts were required on the use of both exchange-traded commodities and over-the-counter instruments; selling their production forward or buying insurance against large price declines; identifying a clear objective to deal with fears of specialization and combining the use of stabilization and market-based instrument to manage oil price risk, given coordination failure in international financial markets. Thus, they recommended that international financial institutions can work with oil companies and developing countries through developing financial instruments for the securitization of oil proceeds and, thus, sharing oil price risk.

## *Comments*

The benefits of using financial instruments to manage oil price volatility in developing countries have been identified in the paper. In spite of the existence of these benefits, neither the government nor the private sector use these financial instruments to manage price risk because of the complexities involved and professional expertise required in managing a hedging program, and lack of adequate government institutional and policy framework.

The issue of instability associated with oil price is very relevant to the Nigerian economy. This is due to the dependence of the economy on oil revenue, which exposes her to the vagaries of external shocks and uncertainties of the international oil market. According to the authors, the application of stabilization and saving funds were ineffective in managing permanent or prolonged oil price changes. Thus, the authors recommended the use of financial instruments as better strategies for managing oil price risks and highlighted the benefits such as:

- Eliminating price uncertainty.
- Transfer of commodity price risk to the market.
- The availability of these instruments in large volumes for single transactions.

This recommendation presents policy choices to the Nigerian government particularly in the area of managing oil price volatility better, given the fact that the government, like in other developing countries, depends largely on the use of stabilization funds in managing oil price shock. Although, the use of stabilization funds has assisted in providing the savings for meeting periodic shortfalls and sustaining fiscal spending, there is the need for the country to manage the external shocks more effectively. Thus, the use of stabilization funds complemented by financial instruments would significantly reduce if not eliminate Nigeria's exposure to oil market instability and, thus, price uncertainty. In the absence of adequate professional capacity to deal in these financial instruments, the Nigerian government can employ the services of consultants knowledgeable in the use of these financial instruments to trade on its behalf.