Management of Oil Revenues in Azerbaijan: Transparency and Effectiveness

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Main findings and key recommendations;

The economic life of Azerbaijan is closely tied to oil. This study claims that the advantage of possessing oil can quickly be spoiled if the resources are merely spent to satisfy short-term interests. However, if managed wisely, e.g. through proper defining and prioritising the long-term interests of the entire society owning the resources, having oil can be extremely beneficial. Proper resource management ensures that the benefits are cumulative, sustainable and consistent. But if these interests are not well-defined, agreed upon, and followed through, then the resources run the risk of being squandered to serve short-term and small group interests only.

The paper analyses different scenarios of using the oil money and advocates for a strategy that would involve the following steps:

- oil rent money needs to be isolated from the economy and collected in an Oil Fund
- the Fund should select the most efficient strategy
- the Fund's resources should initially be invested abroad only
- a diversification plan needs to be prepared
- ethical principles need to be outlined
- the correlation of the percentage share of funds needs to be determined
- the relationship between the risk, expected return, number of investments and overall Fund resources needs to be determined
- principles need to be developed for future possibilities for investing in the domestic business sector

The study claims that the main challenge for Azerbaijan is to develop the non-oil sector to ensure that the economy continues to grow on a sustainable path after the oil boom, meeting both short-term expectations and longer-term demands.

The paper concludes that the efficiency gap in the management of oil money in Azerbaijan is enormous. Improvements need to be made in the oil money accumulation, saving and spending processes in order for this short-term national resource to better serve the long-term development needs of the nation. The necessary changes include redefining and streamlining the Oil Fund in parallel with improvements in budgetary and public investment work.

The recommended improvements regarding the development of the institutional and legal framework will address and make the implementation of the proposed financial strategy for the Oil Fund possible. This will include the development of instructions, guidelines and standards for portfolio investments as well as the rules and standards for transfers from the Fund to the state budget and other domestic public and private uses. The recommended institutional and legal improvements are on the other hand based on the existing situation and current practices, and have political feasibility implications for the suggested changes, which are more extensively discussed in the analysis section of this paper.

Introduction and background information

Azerbaijan is rich in mineral resources, mainly oil and gas. Our country is in the midst of an oil boom brought on by the development of its vast hydrocarbon resources in the Caspian Sea region. Oil revenues are expected to peak in 2011. The country's oil and gas revenues are forecasted to be $200 billion until 2024. The State Oil Fund of Azerbaijan (SOFAZ), created to invest the revenues garnered from the country's extensive oil reserves, is predicted to explode to over $50 billion by 2014. Azerbaijan also expects to boost natural gas production and export starting from 2010. The country has proven natural gas reserves of roughly 2 trillion cubic meters. So, in near- and medium-term perspective, oil and gas revenues will be averaged at 10 billions of dollars.

Azerbaijan has an Oil Fund (SOFAZ) in which oil revenues are deposited, so the lion's share of responsibility for administering oil income falls on the managing of the Oil Fund resources. If Azerbaijan's oil advantage is to benefit not only this generation but also posterity, the Fund needs to be rescued from popular programmes. As in every issue concerning the nation's future, society's long-term interests need to be prioritised in order to prevent short-term or small group interests from taking over the Fund's resources. But first, those long-term interests need to be identified, and then a mechanism for adhering to them needs to be created and implemented.

The Fund was created eight years ago and serves to separate oil revenues from the rest of the economy. However, clearer resource management principles are needed to ensure that the Fund is operated in a way that will maximise the benefit to the overall economy. Money from the Fund is currently being spent with no strategy or criteria to measure the effectiveness of the spending decisions against alternative ways of using the Fund.

Our lives would be different without oil. Oil affects and changes our priorities as well as others' priorities concerning us. And we would run our economy differently if we did not have oil resources to rely upon. However, as a short-term and finite resource, oil cannot be part of our national values and long-term interests, which should ideally be permanent. That leaves room for oil to serve as a temporary instrument only. Oil is short-term, but the Fund is long-term, and the effective management of the Fund should not depend on oil, but behave as if there were no oil at all. Norway's Pension Fund is analogous to Azerbaijan's Oil Fund and could serve as an example of successful management. Oil revenues are isolated from Norwegian society, or, put another way, society is isolated from the oil revenues almost as if the sector did not exist. The strategy of the Oil Fund needs to be at least as efficient. That strategy must flow from the purpose and mission of the Fund. If Azerbaijan wants to ensure an intergenerational balance or save money for the future, then it must resist short-term or any other non-productive programmes and save the maximum amount, which should include at least all of the oil money. By *at least* we mean that the Fund may also generate additional money and that money can be partially accumulated in the Fund.

If the economy can survive without the Oil Fund, then it should be even more robust with assistance coming from the Fund. However, popular programmes must not be allowed to eat the seed corn.

The main strategic issues regarding the Oil Fund are whether to transfer the revenues to the state budget or not, and how to invest the money that remains in the Fund. The principles of modern finance can be applied to help identify the best investment strategy. Diversification is the rule of thumb for lessening risk: investing the oil wealth among a wide range of allocations diversified across many levels (countries, industries, businesses, etc.) may guarantee high returns with lower risk. An index fund, which ensures that the investment in each company is proportional to its market value, can be used as an instrument for diversifying. But diversification only works well with a realistic and prudent approach to every investment decision. Expert advice and some scepticism are necessary, and the pitfalls of the underlying risk lurking behind seemingly high returns need to be carefully analysed. Decisions should not be guided by intuition or astrology. By the same token, non-transparent management is likely to lead to self-satisfying behaviour and inefficient investment decisions. For the management of a public fund such as the Oil Fund, a methodology needs to be prepared in which investment decisions will take into account not only the risks and returns from investments, but also brokerage and investment charges. Higher investment options are often described as a trade-off between a good dinner and a good night's sleep. This is to say that a large number of riskier investments could indeed increase the overall return for an investment portfolio, but then the group responsible for investments needs to have permanent control and keep track of ups and downs in order to be able to change investment decisions in a timely manner. However, a good night's sleep can be guaranteed with government bonds; although these yield lower returns, they are often inflation indexed and entail lower risk.

Meral Karan provides information on how Oil Fund (SOFAZ) resources should be used by the state agencies and treats the Fund as a secondary state budget. However, this approach conflicts with the mission and purpose of the Fund and will not provide the expected benefits.[1]

Let us look at and compare the international experience first. The table below compares the growth of expenditures in several countries. "After the boom" is a relative term, since the countries on the list still produce oil. In addition, "boom" refers here to the rise in production but not to the production itself.

Norway's economy is widely considered to be the most successful in translating its oil money into sustainable development of the country. The Norwegian government's determination to spend its oil revenues wisely is considered the key to the country's economic success as well as its ability to overcome the pitfalls associated with the oil boom.

To manage its oil wealth, Norway established the Petroleum Fund (the prototype of Azerbaijan's Oil Fund), where it accumulated all of its oil money. This money then was transferred into bonds and corporate equities to generate a more stable flow of income that was not dependent on the current rate of oil production in the country. Later, the Fund's functions were integrated with the national insurance scheme, and the fund continued to function under the name of the Pension

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[1] Fighting the resource curse: The Azerbaijan response
Meral Karan

Fund. The strategy of isolating the economy from oil money did not change, however. The amount of money the government may withdraw from the Fund for budgetary purposes is again not a function of the country's current oil production, but of the growth rate of the Fund apart from current oil revenues. However, there were cases when the non-oil deficit of the budget was over the estimated annual non-oil growth of the Fund.[2]

Ulrich F.W. Ernst characterises Norway's strategy in managing the oil revenues as follows:[3]

1. The Norwegian economy is isolated from oil revenues; fund reserves are entirely invested abroad.
The exchange rate between the krone (local currency) and other European currencies is kept stable through economic rather than monetary policies.
The name of the fund has been changed to better reflect its image and mission.
However, there is some emerging sensitivity to "domestic" arguments, since the amount of capital flowing out of the country is increasing while the fund continues to grow. The fund is becoming the largest single-managed fund in the world.

2. Investments are made in both fixed income and equity instruments – since 1998, up to 50% of the total reserves have been permitted to be invested in stock markets (foreign only). Now the investments in foreign markets have reached a level of approximately 40 percent.
The issue is to determine whether a 50% ceiling and the current 40% of investments in the equity market is sufficient or too large. This is more a debate over how much risk can be afforded versus the expected returns.

Now the fund is spreading investments across industries and regions to diversify in an effort to reduce risk. And the management guidelines now limit the fund's investments to 5 percent of the capital of any given company (the limit was 3% before 2007). The fund's exposure in the companies in which it has invested now averages 0.3 percent.

3. Ethical issues are intertwined with the investments. Efforts must be made to avoid conflicts of interest and to make the fund's allocations internationally responsible. The fund should not invest in businesses involved in non-peaceful or environmentally bad practices.
If these ethical standards were to be applied in Azerbaijan, some countries, businesses and particular companies would have to be stricken from the list of the investment options for SOFAZ.

Yelena Kalyuzhnova focuses more on the stabilising role of oil funds, and thus provides analyses and recommendations on how to protect the economy from sharp changes in oil prices.[4]

She sees the role of an oil fund "as formalising – or giving institutional focus to – a set of fiscal rules". She also evaluates the effectiveness of the fund as deriving from this role, i.e. how it is reflected in the policy rules, and how market expectations buffer the economy from price shocks. She admits that "history provides many illustrations, where stabilisation policies relating to commodities collapsed with the rapid exhaustion of finance". She further argues that the

[2] Bjorn Taraldsen. 2007. Management of the Norwegian Government Pension Fund. Norwegian Central Bank. Norway.

[3] Foiling the resource curse: Norway's Petroleum Fund, Ulrich F.W. Ernst

[4] Overcoming the curse of hydrocarbon: goals and governance in the oil funds of Kazakhstan and Azerbaijan. 01-DEC-06 Comparative Economic Studies. Kalyuzhnova, Yelena

stabilising approach should be pragmatic and that there is no universal set of management techniques to make that function optimal.

John Wakeman-Linn, Paul Mathieu and Bert van Selm conclude that oil funds improve coordination between monetary and fiscal policy and that they function best when they can be separated from the state budget (and thus cannot be easily deployed by state agencies). The authors dismiss the necessity of a stabilisation function for oil funds, arguing that "Shortfalls in state budget must be made up through changes/improvements in the state budget".[5]

Jeffrey Davis, Rolando Ossowski, James Daniel and Steven Barnett justify oil funds on political economy grounds: "Such funds may help the government to resist spending pressures if there are constraints on borrowing. These may reflect explicit fiscal rules or may arise from political difficulties in issuing debt."[6]

In addition, the revenue from deploying nonrenewable resources represents a depletion of wealth that could be saved for the future generations. It is also not sustainable for the long-term, and in that respect it differs from other revenue types.

Main findings of your research

The efficiency gap in the management of oil money in Azerbaijan is enormous. Improvements need to be made in the oil money accumulation, saving and spending processes so that this short-term national resource can better serve the long-term development needs of the nation. The necessary changes include redefining and streamlining the Oil Fund in parallel with improvements in budgetary and public investment work.

Sustainable long-term development needs to be a major focus and the only criterion for the use of oil money, as with any public resource. The short-term availability of this resource, however, makes the issue more subtle and brings additional concerns. The need for sustainable long-term development makes the macroeconomic concerns a priority. This is to say that the nation's strategy for the use of oil money needs to focus on the long-term growth of GDP, fiscal stability and independence, and monetary concerns in order to avoid inflation, account for the capacity of the public sector and prevent the creation of an environment conducive to corruption. The strategy must clearly delineate the share and dynamics of national consumption, public investments, government expenditures and trade with other countries with the hydrocarbon resources deducted and oil money added to the national assets. A good strategy will measure and use the oil money not for separate consumption expenditures or investment projects, but in line with all public spending, while accumulating and saving that oil money separately.

The traditional literature suggests that the budgets in oil-producing countries depend on the oil prices on the international market. The Oil Fund thus needs to include a stabilisation function, i.e. a way to bridge budget deficiencies in recession years. This paper argues and takes as a basis for further analysis that (1) it is not the oil price but overall oil revenues that matter (the latter includes

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[5] Oil Funds in Transition Economies: Revenue Management
Azerbaijan and Kazakhstan
John Wakeman-Linn, Paul Mathieu and Bert van Selm, October 16, 2002

[6] Stabilization and Savings Funds for Nonrenewable Resources
Experience and Fiscal Policy Implications
Jeffrey Davis, Rolando Ossowski, James Daniel, and Steven Barnett
2001 International Monetary Fund, April 13, 2001

many other factors, including the amount of oil production) for the decisions between the budget and the Fund, and (2) it is not the budget but the overall income that depends on oil revenues; due to political processes and decisions, the budget is often linked to short-time oil revenues. The Fund could eliminate that link and allow the budget to rely on long-term and secure incomes.

Stabilisation should not protect the economy from fluctuations in oil prices but be negatively linked to the overall revenues. It should link budget transfers to the spending capacity of the government (i.e. how much of government expenditures reach beneficiaries, generate benefits and translate into sustainable development).

Macroeconomic development strategies flow into the financial strategy of the Oil Fund as an institution that accumulates and saves money. Once the extent of the application of oil money (i.e. what exactly needs to be accumulated in the Fund) is determined to reflect the nation's the most pressing long-term interests, then strategies for portfolio investments, transfers to the state budget and public investment projects (if the strategy finds it appropriate) must be adopted and implemented.

A strategy is important for creating the rules for the effective management of the Fund. Having these strict rules is no less important for saving the nation's resources from short-term and populist programmes, as they are for stemming corruption. And the presence of clear efficiency criteria and strict rules along with civil society development facilitates transparency in the management of the Fund. Reciprocally, that transparency becomes a guarantee of the effective management of the Fund and the growth of society's wealth, and thus increases the sense of ownership and the level

General and specific recommendations

The following is the list of recommendations by this paper for the management of oil money in Azerbaijan:

- The amount of transfers from the Fund into the State Budget in any year, shouldn't be above the Fund's average (calculated for the several past years) portfolio profits that will additionally account the fluctuations, population change (that would change the Fund's assets per capita) and the inflation and the overall depreciation the Fund's assets in all invested currencies.
- The diversification principle need to be prepared to illustrate the ceilings expressed in percentages of the Fund's resources can be allocated in each country, in each currency, each type of the business, and each company, as well as ceilings expressed in percentages of the invested company's assets.
- The ethical standards need to be prepared to outline the countries, the businesses and the companies to be excluded from the list of potential investment allocations.
- Principles need to be developed for the future possibilities in investing in the domestic business sector, in the form of the separate bank that would expect the return for the Fund form the investing in the local business higher than from the investment abroad.

- Develop a long-term, diversified investment strategy. With a longer-term spending policy in place, SOFAZ can then shift its investments to a longer-term horizon and be able to diversify from the highly liquid but low-yield investments it made in 2001.

	2004	2005	2006	2007	2008
GDP growth,%	10.2	26.4	34.5	25	10.8
Non-oil sector, %	14.0	8.3	12.0	10	15.7
Oil sector, %	3.0	66.3	63.1	51	7

- The allocation report needs to be prepared for the every portfolio investment by the Fund. The report will replace the feasibility study, as a justification of selection based on transparent criteria and methodology, as well as the appraisal document that would explain why the selection is made vis-à-vis with other possible allocations.

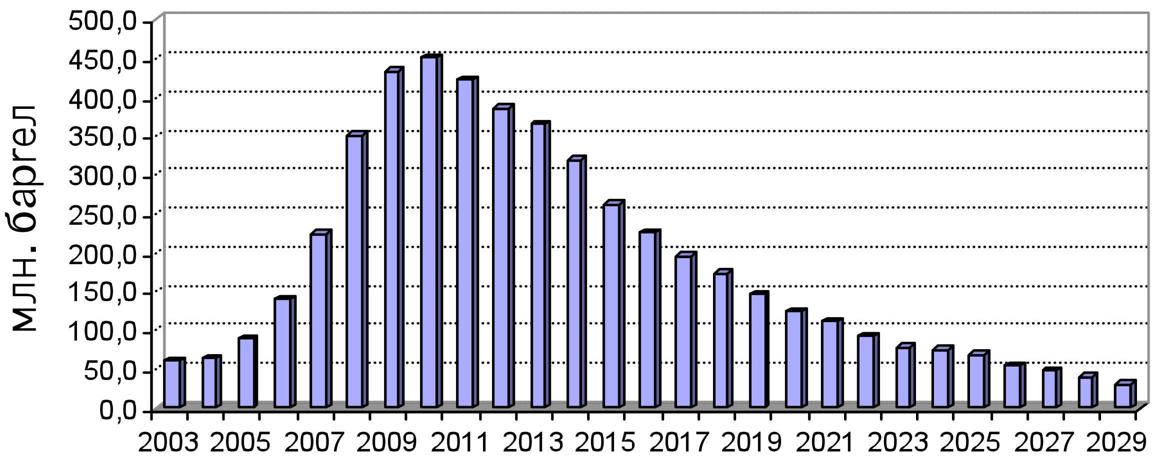
- Clarify the SOFAZ mission and objectives. The decree establishing the Oil Fund explains that it can be used for the "socio-economic progress of the country" and for "solving the most important national problems." Detail mission and objectives are recommended to be settled on.

- The regular (at least, annual) evaluation of the Fund's management needs to be conducted where the Fund's performance (profit, risks, ethical standards and administrative management) will be evaluated against the allocation reports prepared, and the average expectations in the market.

- The standards (financial and ethical) and administrative principles (such as preparation of the allocation report and appraisal, and evaluation principles) need to be developed based on the recommendations here and/or of different expert groups.

Appendixes

Oil Production, Forecast



Source: SSC, 2007

	2004	2005	2006	2007	2008
GDP growth,%	10.2	26.4	34.5	25	10.8
Non-oil sector, %	14.0	8.3	12.0	10	15.7
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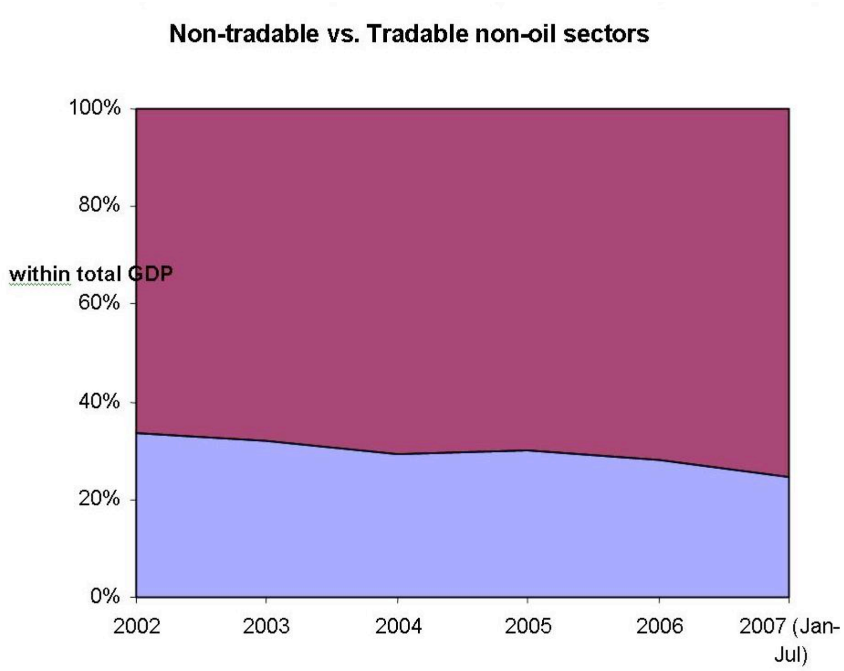
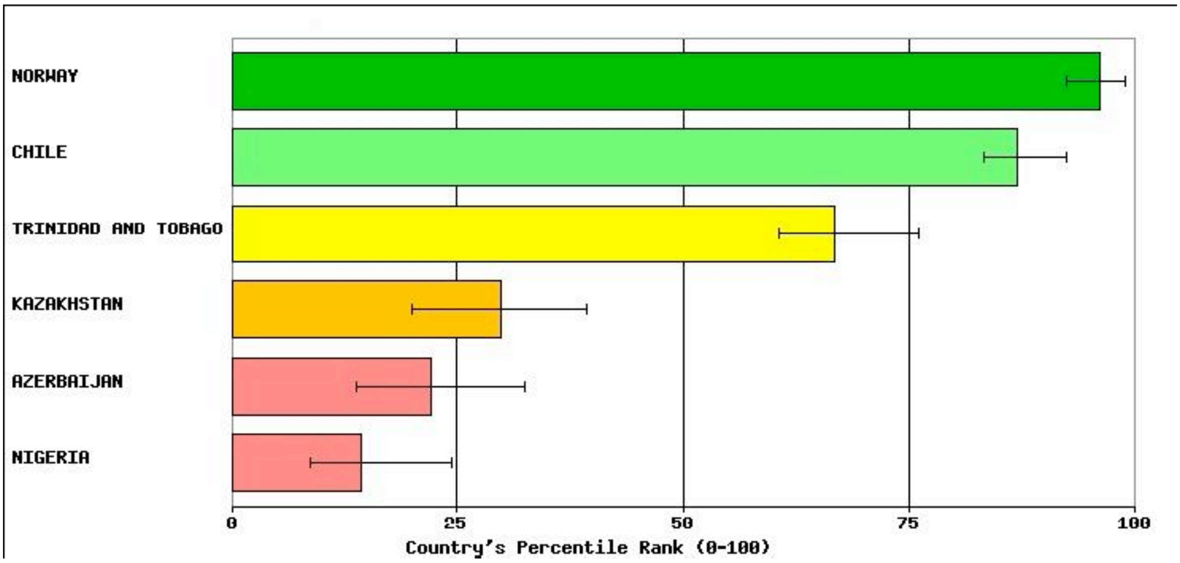
Figure 1: Dynamics of the non-oil economy of Azerbaijan: percentage shares of tradable and non-tradable goods



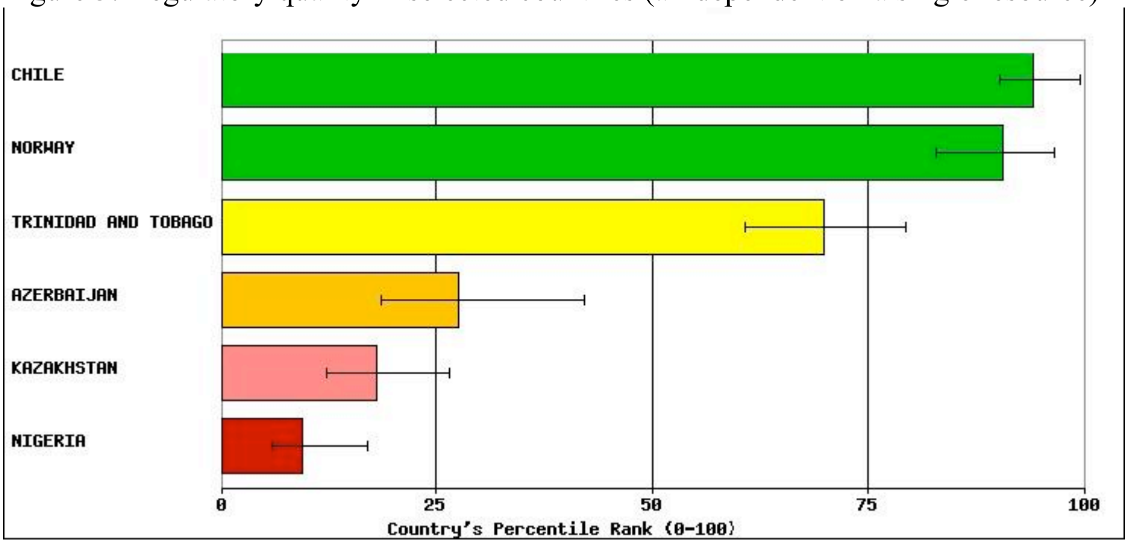
Source: NBA, Azerbaijan

Figure 2: Government effectiveness in selected countries (all dependent on a single resource)



Source: Converting black gold into human gold

Figure 3: Regulatory quality in selected countries (all dependent on a single resource)



Source: Converting black gold into human gold

Table 2: Azerbaijan's Oil Fund balance and non-oil economy over the years, in mln of AZN

year	2007	2008	2009	2010	2011	2012
Oil Fund assets [1]	2659.98	8063.79	11112.32	13799.1	25293.5	56602
Oil Fund expenditures [2]	1107	767	705	705	655	655
Return from Fund assets [3]	106	443	924	1392	1812	2264
Oil Fund balance	-1001	-324	219	687	1157	1609
Non-oil GDP [4]	10366	12755	14859	17038	19513	22346
Fund returns/non-oil GDP	1	3	6	8	9	10

Source: IMF 2007, MOF 2007 and author's calculations

	2004	2005	2006	2007	2008
GDP growth,%	10.2	26.4	34.5	25	10.8
Non-oil sector, %	14.0	8.3	12.0	10	15.7
Oil sector, %	3.0	66.3	63.1	51	7

1. IMF projections (2007-2008 baseline scenario; 2009-2012 sustainable scenario)
2. Ministry of Finance projections
3. With 4% return rate as estimated with Pension Fund in Norway
4. IMF projections

Table 3: Average annual growth of budget expenditures, %

Country	Prior to the boom	Oil boom period	After the boom
Azerbaijan	12.9	46.2	-
Saudi Arabia	27.5	112.5	30
Nigeria	29.6	70	-3.0
Norway	12.7	32	17.2

Source: IMF. International Financial Statistics. 2008

Table 4. Growth in GDP, Oil and Non-oil sector

Source. Statistical Committee of Azerbaijan and Ministry of Finance, 2009

Table 5. Money Market Funds

	2004	2005	2006	2007
JPMorgan Fleming Liquidity Funds	42 146	57 432	2	63 188
Royal Bank of Scotland, Global Treasury Funds plc	16 074	28 887	670	42 822
Barclays Global Investors Funds plc	116	105 442	2	25 106
Goldman Sachs GBP Liquidity Funds	-	-	-	1 490
Wachovia STIF Liquidity Funds	-	-	-	839
DWS Portfolio USD Liquidity Fund	-	4 746	2 201	-
HSBC Global Liquidity Funds plc	55 932	73 439	2	-
Deutche Global Liquidity Managed Fund	29 316	2 422	3	-
	143 584	**272 368**	**2 880**	**133 445**

Source. SOFAZ and IMF, 2008

Table 6. SOFAZ investments

	2001	2002	2003	2004	2005	2006	2007
Money market funds	38 290	182 175	50 890	143 584	272 368	2 880	133 445
Deposits	210 874	199 701	287 550	298 246	479 178	6 484	109 052
Cash in bank accounts	220 041	61 559	18 354	30 221	15 896	60 566	73 713
Total cash and cash equivalents	**469205**	**443435**	**356794**	**472051**	**767442**	**69 930**	**316210**

Source. SOFAZ and Ministry of Finance, 2008

Table 7. SOFAZ money in securities

	2001	2002	2003	2004	2005	2006	2007
Securities	-	128 866	120 313	131 741	504 056	1 198 026	1 776 219
Liquid assets	469 205	443 435	356 794	472 051	757 442	69 930	316 210
	469205	**572 301**	**477 107**	**603 792**	**1 271498**	**1 267956**	**2 092429**

Source. SOFAZ and Ministry of Finance, 2008

Table 8. Cash in Bank accounts

	2004	2005	2006	2007
AZN	-	-	2%	1%
$	99%	53,4%	55%	61%
€	1%	41%	37%	34%
£	-	5,6%	5%	4%
Other	-	-	1%	-

Source. SOFAZ and Ministry of Finance, 2008

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