



## **SPECIAL FOCUS**

### **Oil Exporters: Policies and Challenges**



# Oil Exporters: Policies and Challenges<sup>1</sup>

*Oil exporters faced a challenging policy landscape after the 2014 oil price collapse, as growth prospects deteriorated and fiscal buffers were depleted to varying degrees across countries. Fundamental changes in the oil market in recent years — including rising efficiency in both the production and consumption of oil, make a return to the price levels of the early 2010s unlikely. This Special Focus section asks: (i) How did oil exporters cope with the plunge in oil prices from 2014 to 2016? (ii) What were the immediate monetary and fiscal policy responses? (iii) Have lower oil prices been a catalyst for energy policy reforms? (iv) What are the remaining challenges for exporters? We conclude that oil exporters with flexible currency regimes, relatively large fiscal buffers, and more diversified economies fared better than others, but that overall, most oil exporting economies still face significant policy challenges as their medium-term prospects for growth and fiscal revenues have deteriorated since 2014. This points to an urgent need for reforms to step up diversification efforts and reinforce monetary and fiscal policy frameworks.*

## How did oil exporters cope with the plunge in oil prices?

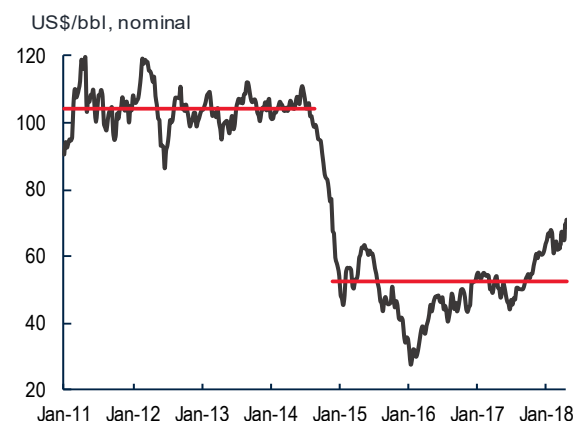
The 70 percent drop in oil prices between mid-2014 and early 2016 was one of the three largest oil-price declines in recent history. Despite retracing some of their losses, oil prices are still around 40 percent below their 2011-14 average (Figure F1). The decline had broad-based and long-lasting effects on oil-exporting emerging markets and developing economies (EMDEs), with nearly 70 percent of these economies registering slowing growth in 2015 and 2016, and most of them experiencing a sharp deceleration in private consumption and investment.

The oil price plunge eroded oil-related revenues, forcing abrupt cuts in government spending that accentuated the slowdown in private sector activity in many regions (World Bank 2016a, 2016b, 2017a; Danforth, Medas, and Salins 2016). This effect was amplified in countries that entered the most recent oil price decline with weaker fiscal positions and higher private sector debt than in previous episodes (BIS 2016).

Idiosyncratic factors, including sanctions against the Russian Federation, geopolitical tensions in the Middle East, and conflict and deteriorating security conditions in some low-income Sub-Saharan producers (e.g., Chad, South Sudan) also exacerbated the impact of the oil price shock in the affected countries. In turn, economic headwinds in Russia and members of the Gulf Cooperation Council (GCC) had adverse cross-border spillover effects through reduced trade flows, remittances, foreign direct investment, and grants (World Bank 2015a, 2016c).

Oil exporters with floating exchange rate regimes and diversified economies (e.g., Malaysia, Qatar) recovered more quickly than in those with fixed exchange rates and high export concentrations (Figure F2).<sup>2</sup> Oil exporters with large foreign exchange reserves and more stable inflation also showed greater resilience (Grigoli, Herman, and Swiston 2017; World Bank 2016a). Finally, income inequality and political instability weakened the ability of some oil-exporting economies to weather low oil prices (Ianchovichina and Onder 2017).

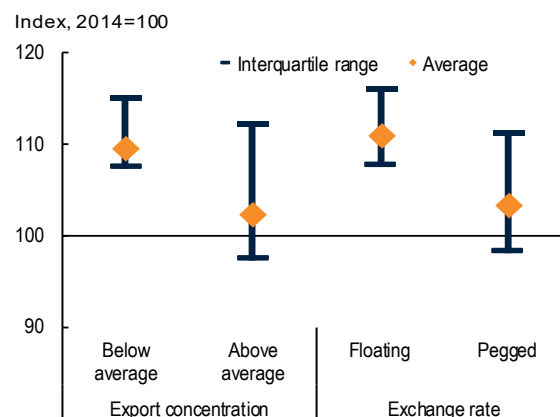
**F1** Oil price



Source: World Bank.

Notes: Average of Brent, Dubai, and WTI. Last observation is April 20, 2018.

**F2** GDP changes since 2014, by group



Sources: IMF, UNCTAD, World Bank.

Note: Sample includes 31 oil-exporting EMDEs. See endnote #2 for details.

## What were the immediate monetary and fiscal policy response?

### Monetary policy

Many oil-exporting EMDEs experienced sharp currency depreciations and rapid declines in foreign exchange reserves in 2014–16. Countries with floating exchange rate regimes were better able to stabilize reserves, but generally suffered sharper initial depreciations (Figure F3).<sup>3</sup> Monetary authorities in several countries intervened in foreign exchange markets to support their currencies (e.g., Angola, Azerbaijan, Bolivia, Kazakhstan, Malaysia, Nigeria, Russia, Sudan, Turkmenistan), and many raised interest rates to contain inflation amid large currency depreciations (e.g., Angola, Azerbaijan, Colombia, Ghana, Kazakhstan, Nigeria, Russia, Trinidad and Tobago) or to support currency pegs (e.g., Bahrain, Kuwait, the United Arab Emirates).

The erosion of foreign exchange reserves forced some currency devaluations and encouraged a shift to more flexible exchange rate regimes in a number of countries (e.g., Azerbaijan, Nigeria, Russia). In contrast, GCC countries used strategic reserves to maintain their currency pegs, despite intermittent exchange rate pressures (World Bank 2016b).

Central banks in oil-exporting EMDEs also took steps to mitigate tightening banking sector liquidity. In some countries, sovereign wealth and pension funds were used to reduce liquidity pressures in the banking sector (e.g., Azerbaijan, Kazakhstan; Sommer et al. 2016).

### Fiscal policy

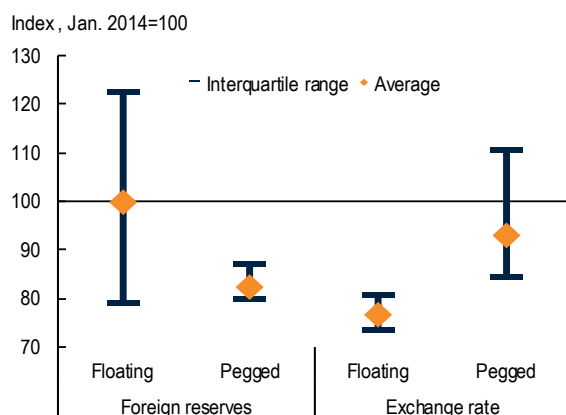
Many oil-exporting EMDEs undertook fiscal consolidation measures to realign spending with revenues despite rising economic slack and diminishing long-

term growth prospects (e.g., Algeria, Angola, Azerbaijan, Iraq, the Islamic Republic of Iran, Kuwait, Nigeria, Russia, Saudi Arabia, the United Arab Emirates; Danforth, Medas, and Salins 2016). Compared with previous episodes of declining oil prices, the impact on public finances in EMDE oil exporters was larger, reflecting the magnitude and duration of the oil price decline (World Bank 2018). The effect was compounded in some countries by weaker initial fiscal positions. Fiscal sustainability gaps continued to widen in 2015 and 2016, and government debt ratios rose on average by 11.4 percentage points, compared with an average of only 0.9 percentage point in past episodes (IMF 2017a; World Bank 2017a).

The deterioration in budget deficits and fiscal sustainability gaps was greater in oil-exporting EMDEs with higher reliance on oil-related revenues, while countries with more flexible exchange rate regimes generally fared better, in part because real exchange rate depreciation mitigated revenue declines and spurred needed adjustment within the private sector (Figure F4).<sup>4</sup> A number of oil exporters that had previously built up buffers in sovereign wealth funds (SWFs) used such buffers to alleviate fiscal and exchange rate pressures (e.g., Algeria, Azerbaijan, Kazakhstan, Kuwait, Saudi Arabia, the United Arab Emirates; World Bank 2016b).<sup>5</sup> Others have chosen to issue debt on international markets, reflecting low borrowing costs (Lopez-Martin, Leal, and Martinez 2016; Alberola-Ila et al. forthcoming).

Several countries also implemented tax reforms to compensate for the loss of government revenues and to insulate themselves from future oil price fluctuations. This included the introduction of taxes on goods and services or value-added taxes (e.g. Malaysia, Saudi Arabia, the United Arab Emirates), as well as raising existing VAT rates (Colombia). However,

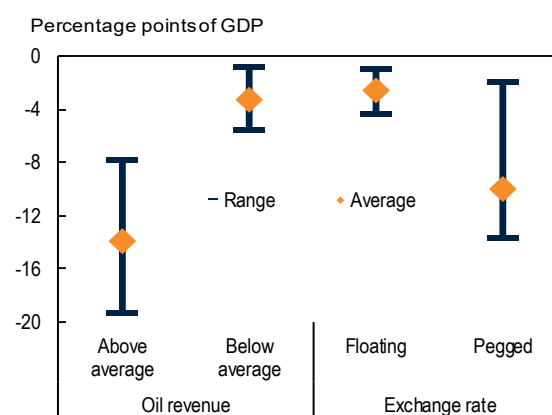
**F3** Exchange rate pressures since 2014



Sources: BIS, Haver Analytics, IMF, World Bank.

Notes: Nominal effective exchange rate and foreign reserve levels indexed to 100 in January 2014. Last observation is March 2018. See endnote #3 for details.

**F4** Change in fiscal balance since 2014



Sources: IMF, World Bank.

Notes: Change in overall fiscal balance in percent of GDP from 2014 to 2016. See endnote #4 for details.

implementation has stalled in some cases (e.g., Bahrain, Kuwait, Oman, Qatar), while exemptions have limited revenue growth in some others (Malaysia).

Expenditure cuts and tax hikes have helped lower the fiscal breakeven oil price in oil-exporting EMDEs since 2015, although they remain higher than the current oil price in some countries (e.g., Bahrain, Saudi Arabia, Oman, the United Arab Emirates; Baffes et al. 2015; World Bank 2017a; World Bank 2017b).

### Have lower oil prices been a catalyst for reforms?

The collapse in oil prices provided impetus for reforms, particularly of energy subsidies. In countries where such reforms were undertaken, energy subsidies represented nearly 6 percent of GDP before the 2014-16 oil price collapse. Between mid-2014 and end-2016, a majority of oil-exporting EMDEs introduced subsidy reforms, although in various forms and to varying degrees across countries. Several oil exporters have also reduced utility subsidies. In some cases—for instance, in GCC countries—subsidy reform was a significant break from past policy (Krane and Hung 2016; World Bank 2017b).

The aim of these reforms was to restore fiscal space, discourage wasteful energy consumption, and strengthen programs that better target the poor (IMF 2017b). Encouragingly, the design and implementation of recently-implemented energy subsidy reforms have been superior, focusing on longer term objectives, proper phasing in of price increases, and better communication (Clements et al. 2013; Asamoah, Hanedar, and Shang 2017). In many cases, recent reforms have also included measures to mitigate the impact on the poor and to strengthen social safety nets (e.g., Algeria, Angola, Saudi Arabia).

Beyond subsidy reforms, several large oil-exporting EMDEs have also laid out medium- to long-term programs to reduce reliance on the energy sector. These reform plans include: reducing labor market rigidities (e.g., Oman, Saudi Arabia), supporting foreign investment (e.g., Saudi Arabia), expanding infrastructure investment (e.g., Malaysia), and improving the business environment (e.g., Algeria, Bahrain, Brunei Darussalam, Kazakhstan, Nigeria; Figure F5).<sup>6</sup> However, in some cases, the structural reform agenda has faced legislative or implementation delays (e.g., Algeria, Kazakhstan) or has been scaled back as fiscal pressures receded (e.g., privatization efforts in Russia).

### What are the remaining challenges for oil exporters?

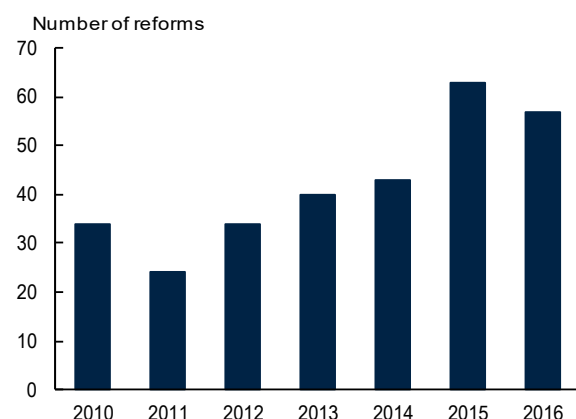
The prospect of persistently low and perhaps more volatile oil prices intensifies the need for improved monetary and fiscal policy frameworks as well as reforms to reduce reliance on oil, increase value added and productivity in the non-extractive sector, boost competitiveness, skills acquisition and adaptability.

#### Monetary policy

Reforms to monetary policy frameworks could help foster resilience to oil price fluctuations by taking more explicit account of these fluctuations into policy objectives. This should help limit procyclicality and ensure smoother exchange rate adjustments during oil price cycles.

For countries with floating exchange rate regimes, options include targeting the domestic-currency price of exports, the GDP deflator, or even nominal GDP (Frankel 2010, 2017; Catao and Chang 2013). These options are viewed as delivering higher welfare gains and stability compared to a policy that targets con-

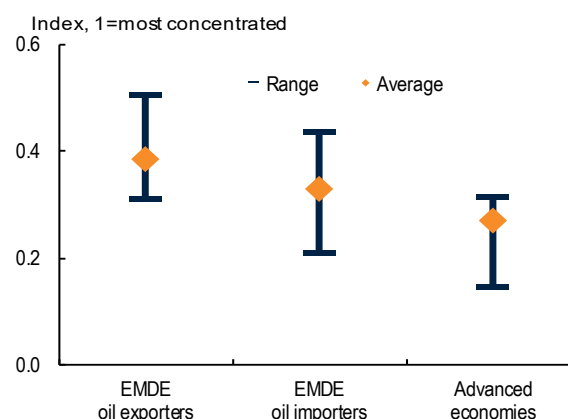
#### F5 Reforms in oil exporters



Source: World Bank (Doing Business database).

Note: Sample includes 35 oil-exporting EMDEs. See endnote #6 for details.

#### F6 Export concentration, 2016



Sources: UNCTAD, World Bank.

Note: Sample includes 34 oil-exporting EMDEs. See endnote #7 for details.

sumer price inflation. Countries with currency pegs—especially small open economies with limited financial market depth—could also see advantages by adding oil prices as part of their targeted currency basket. Irrespective of currency regimes, a criterion for judging whether monetary policy is appropriately countercyclical is whether the nominal exchange rate is allowed to move in line with terms-of-trade shocks.

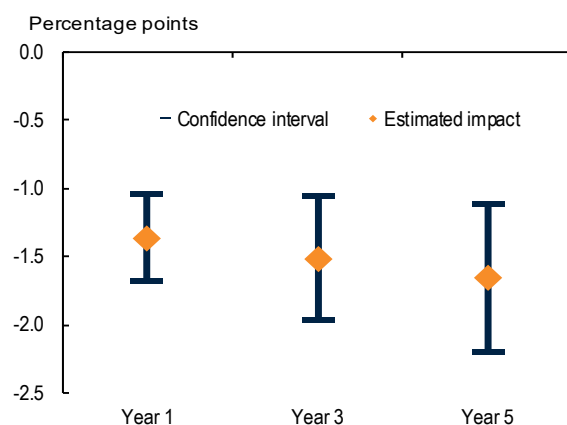
### Fiscal policy

Fiscal reforms also remain necessary in a majority of oil-exporting EMDEs. Only one-fourth of oil-exporting EMDEs have fiscal rules to smooth the impact of oil price cycles on activity and public finances. This suggests the need for stronger fiscal frameworks to help reduce procyclicality and to establish a firmer foundation for long-term fiscal sustainability (Mendes and Pennings 2017; Devarajan 2017). This includes linking spending and subsidies to revenues, as well as basing fiscal projections and structural budget balance calculations on prudent assumptions about potential output and equilibrium oil prices. Oil price hedging and indexation of government bonds to oil prices could also help reduce exposure to short-term fluctuations in oil prices (Frankel 2017).

### Diversification

Over the medium term, diversification away from oil will be needed to raise GDP per capita and improve growth prospects for oil-exporting EMDEs. Cross-country studies underscore that greater diversification of exports and government revenues bolsters long-term growth prospects and resilience to external shocks (Lederman and Maloney 2007; Hesse 2008; IMF 2016). At present, oil-exporting EMDEs exhibit a much higher degree of export concentration than oil-importing EMDEs and advanced economies (Figure F6).<sup>7</sup>

#### F7 Growth response to contractions



Source: World Bank.

Notes: Contractions are defined as years of negative growth from the year after the output peak to output trough. See endnote #8 for details.

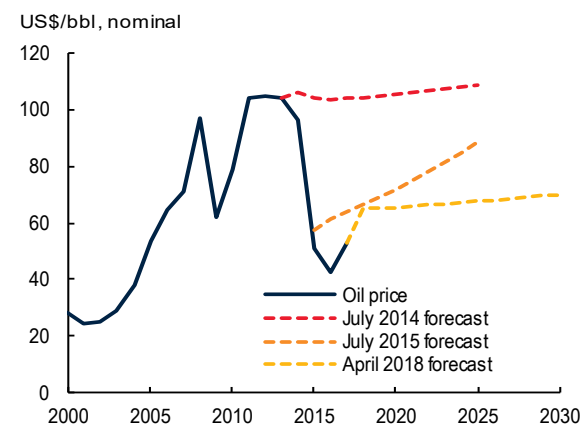
The successful diversification experience of some energy producers (e.g., Malaysia, Mexico) suggests the need for broader diversification efforts, especially along the energy supply chain of oil, natural gas, petrochemical sectors as well as energy intensive industries. This involves reforms to improve the business environment, education, and skills acquisition (Calen et al. 2014). Attracting capital flows to non-resource sectors may also encourage such efforts. While incremental diversification around resource sectors can help foster learning and the adoption of new technologies, proper regulatory and institutional conditions need to be in place to attract new investments, help the development of higher value-added export sectors, and boost participation in regional and global value chains. Regulations and institutions that slow the emergence of new sectors should be identified and reformed to support efficiency-seeking and productivity-enhancing investments (Mahmood 2017).

### Conclusion

Oil exporters faced significant policy challenges since the 2014-16 collapse in oil prices, but those with flexible currency regimes, relatively large fiscal buffers, and diversified exports fared better than others. A period of low oil prices has also compelled policy-makers in many countries to undertake long-needed reforms, including reducing fiscally-costly energy subsidies and developing plans to reduce reliance on the energy sector.

However, the pace of reforms has been slow and the persistently low oil prices continue to cast a long shadow on potential growth, (Figure F7).<sup>8</sup> The expectation that oil prices will remain markedly lower than previously expected increases the urgency of accelerating diversification efforts, boosting resilience, and increasing fiscal sustainability (Figure F8). Oil exporters

#### F8 Oil prices, history and forecasts



Sources: World Bank (2014, 2015c, this report).



should also prepare for episodes of large price fluctuations as unexpected changes in oil supply (e.g., geopolitically-driven disruptions) or demand conditions (e.g., changing growth prospects in major EMDEs) remain possible. This emphasizes the need to reinforce fiscal rules and ensure that monetary policy frameworks facilitate orderly adjustments to terms-of-trade shocks.

## Endnotes

1. This section draws heavily from Stocker et al (2018).
2. The Herfindahl-Hirschmann export concentration index measures the degree of product concentration. Values closer to 1 indicate a country's exports are highly concentrated on a few products. "Above average concentration" and "below average concentration" groups are defined by countries above or below the sample average for export concentration in 2014. Exchange rate classification is based on the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions database. Countries are ranked from 0 (no separate legal tender) to 10 (free float). "Pegged" refers to countries with a ranking of 1 to 6 while "Floating" denotes those with rankings of 7 to 10 and includes countries with horizontal bands and other managed arrangements.
3. Foreign reserve sample includes nine oil-exporting EMDEs for which data is available (Albania, Angola, Bolivia, Colombia, Kazakhstan, Malaysia, Nigeria, Qatar, and Russia). The nominal effective exchange rate sample includes seven oil-exporting EMDEs for which data is available (Algeria, Colombia, Malaysia, Nigeria, Russia, Saudi Arabia, and the United Arab Emirates).
4. Sample includes 27 oil-exporting EMDEs (excludes Albania, Bolivia, Brunei Darussalam, Ghana, Libya, Myanmar, South Sudan, and Turkmenistan). Change in overall fiscal balance is measured from 2014-16. Above average and below average oil revenue groups are defined by countries above or below the sample average of oil revenues as a share of GDP based on 2014 data.
5. Approximately 60 percent of oil-exporting EMDEs have at least one SWF.
6. Number of reforms reported in Doing Business in the following areas: making it easier to start a business, making it easier to deal with construction permits, making it easier to get electricity, making it easier to register property, making it easier to get credit, making it easier to protect minority investors, making it easier to pay taxes, making it easier to trade across borders, making it easier to enforce contracts, and making it easier to resolve insolvency. Sample includes 35 oil-exporting EMDEs.
7. Sample includes 34 oil-exporting EMDEs (excludes South Sudan), 116 oil-importing EMDEs, and 36 advanced economies.
8. Contractions are defined as the years of negative output growth from the year after the output peak to output trough. Sample includes 9 oil-exporting EMDEs: Bolivia, Columbia, Ecuador, Iran, Kazakhstan, Kuwait, Russian Federation, Saudi Arabia, and Venezuela. Dependent variable defined as cumulative slowdown in potential growth after a contraction event. Diamonds show coefficient estimates, while vertical lines show shock +/- 1.64 standard deviations (90 percent confidence bands).

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