RESOURCE UPDATE: OIL IN ANGOLA

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RECOMMENDATIONS

1. In countries that rely heavily on oil exports, economic policy-making should be guided by medium-term budget planning that provides for primary non-oil budget deficits. In addition, it is recommended that conservative oil price projections are included in the budget.

2. Public authorities in countries heavily reliant on oil exports should: 1) strengthen the management of public finances through the introduction of clear bidding processes for contracts, and 2) adopt flexible policies on debt, international reserves and foreign exchange.

3. In countries with weak social services and infrastructure it is not the best option to save the money generated by massive oil exports in sovereign wealth funds. It is also not a good option to use the revenue generated from oil to finance current expenditure. Instead, it is suggested that countries increase available domestic capital by *investing in investment.*

4. Problems often associated with resource abundance may be avoided by seeking to diversify the economy through prudent macro-economic policies that encourage investment. Governments are encouraged to adopt the right mix of economic policies. They should furthermore enable the growth of dynamic economies by creating attractive institutional, legal and regulatory environments.

EXECUTIVE SUMMARY

The remarkable performance of Angola's economy during the period 2002-2008 may be attributed to the steady growth of the country's oil and non-oil sectors. The years 2005, 2006, 2007 and 2008 in particular stand out as the best since independence. Despite not yet hitting the single-digit mark, the country has made remarkable progress in reducing inflation since the end of the civil war. [ii] Angola faces three major macroeconomic challenges: 1) to manage its oil wealth before the expected decline in production, aiming to ensure both budgetary and long-term debt sustainability; 2) to improve the competitiveness of its economy; and 3) to develop the non-oil and non-extractive sectors of its economy. This paper analyses the way which institutions are relevant, not only for the depth of democracy, but also for ensuring that Angola turns its oil resource into a blessing rather than a curse.

INTRODUCTION

Today, Angola is considered part of a group of intensive oil-producing countries.[iii] During the years of central planning, the combined effects of a devastating civil war and the over-valuation of the kwanza lead to the collapse of the non-oil sector of the economy. Between 1997 and 2008, the non-oil sector registered a considerable recovery with an average annual growth of 11.6%.[iv] However, the parallel expansion of the oil sector – at a rate of 7.8% – means that for the past eight years, the contribution of the non-oil sector to the Angolan economy has remained stable at around 40%.[v]

RESOURCE ABUNDANCE: BLESSING OR CURSE?

There often appears to be a negative relationship between the abundance of resources – particularly of oil – and economic growth. Resource abundance affects growth through different channels.[vi] Failures observed in natural resource-based development have been explained not only by so-called "Dutch Disease" dynamics, but also by the resource curse thesis, which focuses on governance issues related to resource abundance, such as the rent-seeking, corruption,[vii] conflict, as well as a lack of accountability and transparency.

THE ROLE OF INSTITUTIONS IN FIGHTING THE CURSE

A recent empirical analysis[viii] returned again to the question of whether the abundance of natural resources could contribute to growth. It concluded that the potential contribution of resource wealth to growth depends on the quality of governance. In developing countries in particular, the quality of regulations, the predictability of regulatory change as well as transparency and accountability mechanisms in the public sector (including anti-corruption policies) are very important for the effective management of natural resources and, ultimately, for growth.

Intensity

OIL ~~DEPENDENCE~~ AND ECONOMIC GROWTH

A 2010 econometric study,[ix] involving 23 oil exporting countries, shows that the applicability of the "resource curse" should be treated with caution when externalities related to the oil sector are highly dependent on the level of oil ~~dependence~~ intensity of the economy. In economies with low oil ~~dependence,~~ intensity it appears that incentives to strengthen public and private sector institutions lead to external positive cross-sector linkages. On the other hand, lower incentives in economies with high oil intensity ~~dependence~~ negatively affect public and private sector institutions and therefore lead to external negative cross-sector linkages. Nir Klein[x] explores the linkage between the oil and the non-oil sectors. In Angola's case, he concludes that there is a direct and positive impact of the oil sector on the non-oil sector. However, the presence of a poor investment climate, poor infrastructure and inefficiency of public expenditure become obstacles to the development of the non-oil sector. In this context, and given that in the long term the poor institutional setting has an adverse impact, it is necessary to improve these indicators, in order to retain existing synergies and avoid the negative external factors that are observed in other highly oil intensity dependent economies. This progress would allow a larger positive reach between the two sectors, which would be reflected in accelerated growth in the overall Gross Domestic Product (GDP).

PEAK OIL AND THE FUTURE OF DEMOCRACY IN ANGOLA

The Center for Studies and Scientific Investigation of the Catholic University of Angola (CEIC/UCAN Centro de Estudos e Investigação Científica da Universidade Católica de Angola)[xi] has developed four different scenarios for *peak oil* in Angola. The working options are: (1) a daily production of 2 million barrels and reserves of 9 billion barrels (BP, June 2009); (2) reserves admitted by the Government with a value of 13.5 billion barrels; (3) reserves of 19 billion barrels (WTI, 2008); and (4) 24.5 billion barrels, considering the technological progress that would allow oil extraction from greater depths and to extract other types of oil such as tar sand, heavy oil, oil shale, etc. According to these scenarios, the maximum peak of Angolan oil production (Angolan peak oil) could occur either in 2015, in 2018 or in 2022 or finally in 2025. More conservative World Bank[xii] estimates refer to an even earlier peak oil date of between 2010 and 2014. This estimate is consistent with calculations made on the level of the oil world reserve. Currently, worldwide, three barrels of oil are consumed for each barrel discovered.

The years that separate us from Angolan peak oil[xiii] indicate that oil-generated income will not be enough to finance the future growth and diversification of the Angolan economy. That being said, the turning point of production will not mean the end of the oil generated income. The fiscal income from oil extraction and export will be proportionally reduced. Between 2010 and 2014, in the most optimistic scenario, the Angolan state income generated by the oil will be, on average, around US$35 billion.

Even though there is a set of factors suggesting a resumption of economic growth over the next year, there are serious political risks that need to be considered[xiv]. The major long-term political risk is the weakness of Angola's democracy. Added to this is fear regarding political stability in the context of presidential succession. Among 37 African countries studied, Angola's long-term political risk is surpassed only by that of the Democratic Republic of Congo (DRC) and of Zimbabwe.[xv]

DISCUSSION OF THE GROWTH MODEL

The Angolan economic growth model continues to rely on the oil sector, which is highly capital intensive and dependent on sophisticated technology. Angolan oil is increasingly being extracted in deep and ultra-deep waters. The sunk costs are increasing and the return on the cost of oil, by the oil companies, is also faster. The linkages to other economic sectors are marginal, with the exception of the public works and financial sectors. Even though the 'natural resource curse' is predominant in those countries with a high oil ~~dependence~~ intensity, economic development in Angola seems to suggest otherwise. [xvi] Since 2006, the average annual rate of change for production in the non-oil sector has systematically surpassed that of the oil sector.[xvii]

THE SOVEREIGN WEALTH FUND

In 2006, the Council of Ministers instituted a reserve fund[xviii] into which is transferred the difference between the price of the Angolan oil in the world market and the price that was set by the government in the State Budget. The intended use of the resources accumulated in this fund is not accounted for by the Government. This is particularly true during the shocks on the Angolan economy caused by the international financial and economic crisis. International experience furthermore indicates that oil funds that are based on tight operational regulations may complicate budgetary management. [xix] It is for these reasons that the IMF supports the establishment of a mid-term budget to guide economic policies. It is only in this framework that an oil fund, based on well-defined and flexible regulations fully integrated in the budgeting process and subject to processes that guarantee transparency, is viable and can promote the strengthening of the systems of public finance management.[xx] In the long run, the setting of the oil price constitutes a challenge, due to its volatility. However, stipulating the oil price in the budget could assist in limiting the actions of public authorities with a view to improving transparency and accountability.

In 2008, following Angola's experience with the reserve fund, Angolan President José Eduardo dos Santos formed a committee to establish the Sovereign Wealth Fund (SWF) - Fundo Soberano Angolano (FSA)[xxi]. He argued that, "in the current global economic situation, the State needs to have mechanisms that guarantee the effective management of its resources and that protect the country from external vulnerability and unstable economic cycles". The former minister of Finance Eduardo Severim Morais added that this fund would be fed by the wealth generated by the profit from oil and launched in 2009, with the objective of investing the money outside of Angola. In the second quarter of 2010, a draft proposal on the FSA was sent to the Angolan government. To

However only last year (January)

~~date~~, however, the fund has ~~not~~ been created. Should the SFA be created, Angola is ~~will be~~ the sixth country in the African continent to create a national wealth fund, after Algeria, Botswana, Libya, Mauritania and Nigeria.

The SFA intends to ensure an intergenerational transfer of wealth as well as to create enough fiscal space to allow for counter-cyclical policy implementation. During the discussion of the annual budget (2010), the Angolan government announced plans to create a fund "that would receive up to 100,000 barrels per day of oil revenue, worth around US$280m per year at current prices to finance projects in water and power networks".

In Angola's current conditions, saving the money generated by massive oil and diamond exports in a sovereign wealth fund [xxii] is not the best option. It is also not a good option to use the oil and the diamond generated income to finance current expenditures in the budget - Orçamento Geral de Estado. The creation of the Angolan Development Bank - Banco de Desenvolvimento de Angola (BDA) in 2006 was a good decision. Five percent of the financing for the BDA is from oil-income and 2% from the diamond sector, and the bank offers loans to Angolan entrepreneurs. The only drawback of this BDA is that it runs the risk of becoming another channel for patronage, oiling the political machinery of a patrimonial system.

CONCLUSION

The impact of the discovery and the exploitation of a natural resource is not in and of itself a blessing or a curse. A rich gift of natural resources is not necessarily an obstacle; it can also be a great support for economic development.

NOTES

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[ii] IMF (2010): *Angola: Second and Third Reviews Under the Stand-By Arrangement and Request for Waivers of Nonobservance of Two Performance Criteria Series*: Country Report No. 10/302, Washington DC.

[iii] Klein, Nir.(2010) : *The Linkage between Oil and the Non-oil Sectors – A Panel VAR Approach.* IMF Working Paper 10/118.

[iv] IMF (2010): *Angola: Second and Third Reviews Under the Stand-By Arrangement and Request for Waivers of Nonobservance of Two Performance Criteria Series*: Country Report No. 10/302, Washington DC.

[v] IMF (2010): *Angola: Second and Third Reviews Under the Stand-By Arrangement and Request for Waivers of Nonobservance of Two Performance Criteria Series*: Country Report No. 10/302, Washington DC.

[vi] Frankel, Jeffrey A. (2010): *The Resource Curse : A Survey.* NBER Working Paper No. 15836.

[vii] World Bank (2010) : Silent and Lethal – How quiet corruption undermines Africa's development efforts in *Africa Development Indicators 2010,* Washington DC.[vii]

[viii] Iimi, Atsushi (2007) : *Escaping from the Resource Curse: Evidence from Botswana and the Rest of the World.* IMF Staff Papers. Vol. 54, No.4.

[ix] Klein, Nir.(2010) : *The Linkage between Oil and the Non-oil Sectors – A Panel VAR Approach.* IMF Working Paper 10/118.

[x] Klein, Nir.(2010) : *The Linkage between Oil and the Non-oil Sectors – A Panel VAR Approach.* IMF Working Paper 10/118.

[xi] CEIC/UCAN (2010): *Relatório Económico de Angola 2009,* June 2010, Luanda.

[xii] World Bank (2007): *Angola: Oil, Broad-base Growth and Equity,* World Bank Country Study N°. 40531, Washington DC: World Bank.

[xiii] CEIC/UCAN (2010): *Energia em Angola.* Report 2010. October 2010, Luanda.

[xiv] About external and budget's risks due to the reduction of the mid-term oil's production levels, see Mitchell, J. V., and Stevens, P., 2008, "*Ending Dependence: Hard Choices for Oil-Exporting States*", Chatham House Report, London: Chatham House.

[xv] BMI (2010), *Angola Business Forecast Report,* Business Monitoring International, 2010.

[xvi] Klein, Nir.(2010) : *The Linkage between Oil and the Non-oil Sectors – A Panel VAR Approach.* IMF Working Paper 10/118.

[xvii] CEIC/UCAN (2010): *Relatório Económico de Angola 2009,* June 2010, Luanda.

[xviii] See, for example, <http:/ /www.swfinstitute.org> and <http:/ /www.angonotícias.org>.

[xix] IMF (2010) : *Angola: Second and Third Reviews Under the Stand-By Arrangement and Request for Waivers of Nonobservance of Two Performance Criteria Series*: Country Report No. 10/302, Washington DC.

[xx] IMF (2010) : *Angola: Second and Third Reviews Under the Stand-By Arrangement and Request for Waivers of Nonobservance of Two Performance Criteria Series*: Country Report No. 10/302, Washington DC.

[xxi] About what the sovereign wealth fund are and their typology, see, for example, IMF (2008): *Sovereign Wealth Funds – A Work Agenda,* Prepared by Monetary and Capital Markets and Policy Development and Review Departments, Approved by Mark Allen and Jaime Caruana, International Monetary Fund.

[xxii] See, for example, IMF, 2010, *Angola: Second and Third Reviews Under the Stand-By Arrangement and Request for Waivers of Nonobseevance of Two Performance Criteria,* Country Report No. 10/302, Washington. DC.