

Cover page:

•I thank you all for participating in this timely discussion. I think what unites everyone here is a keen appreciation of how difficult it is to translate the finite resources provided by nature into sustainable development. I think we also share a deep desire to see the resource-rich countries of the Caspian avoid the mistakes of so many others that have squandered their resource wealth. But what may be less widely accepted is the important role that transparency, a vibrant civil society, and real democracy play in ensuring effective use of petroleum revenue.

My comments will draw on findings of the Caspian Oil Windfalls report, which studies the systems in place in Azerbaijan and Kazakhstan to manage natural resource wealth.

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•There is a sensible and widely held misconception that all things being equal, countries with oil wealth are better off than those without. However, numerous studies have pointed to the opposite, and a variety of terms has developed to describe this odd phenomenon.

•... perhaps the most colorful was the term coined by OPEC's founder, Juan Pablo Perez Alfonzo, who called it "the devil's excrement"

This panoply of terms all reflect the findings of numerous studies which point to the following: countries rich in natural resources are likely to have slower economic growth, greater poverty, higher debt, less democracy, worse governance, and greater likelihood of civil war than countries lacking resource wealth. For data on this I invite you to read chapter 1 of our book.

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Let me spend a couple of minutes on the causes of this before turning more specifically to Azerbaijan and Kazakhstan.

While there have been numerous studies on the economics of the resource curse--the so-called Dutch Disease--analysts are increasingly coming to realize there is a political dimension to the resource curse. And it comes to this: In petroleum and mining, natural resource revenue flows through government. The large rents generated by these contracts means that leaders have little incentive to share power. Often a host of negative consequences follows. It is not a coincidence that most of the world's oil producers are not democracies.

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•And it is the absence of democracy that distorts economic policy. Instead of seeking legitimacy through the electoral process, rulers seek it through spending. The result is often excessive spending, rent-seeking and corruption, inflation, debt accumulation, and political instability.

•Does this mean that the resource curse is destiny? By no means. Az and Kaz have already shown a commitment to avoid past mistakes of others. They have

been extremely careful to avoid large increases in spending, to control inflation, and to maintain exchange rate stability. Azerbaijan has adopted a poverty reduction plan, and both countries have created oil funds to help manage their petroleum earnings.

But a commitment to good revenue management goes beyond fiscal policy. It requires institutionalization of good governance. While today's leaders may have the competence and commitment to provide good fiscal policy, there must be institutions to protect against future leaders who are less visionary. And in this regard, there is additional progress that can be made in Azerbaijan and Kazakhstan.

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- Let me devote my remaining time to a brief discussion of the challenges facing these two countries.
- Azerbaijan has done a good job of restoring macroeconomic stability and economic growth. But it faces a number of challenges in order to avoid the resource curse.
- The first is an extremely short window of opportunity. Oil revenues will peak around 2010 and decline rapidly thereafter. Unless new fields are discovered, oil resources will be depleted in about 20 years.
- In this span, Azerbaijan has to address its widespread poverty, with an estimated half of the population living in poverty and about a million persons displaced following the war over Nagorno-Karabakh in the early 1990's.
- This territorial conflict with Armenia has never been settled and remains a ticking time bomb. The challenge will be finding a final settlement which does not consume a large share of the country's limited petroleum earnings to achieve a military solution.
- Another major challenge will be development of the non-oil sector. Azerbaijan's manufacturing sector is in a severe state of decline even as annual economic growth, driven by oil, hovers around 10% (SHOW NEXT SLIDE)
- It will also be important to improve accountability over the oil fund which in a few years time will be larger than the government budget. This fund currently exists on the basis of a presidential decree with all spending decisions made by the president. A sounder foundation would be the passage of an oil fund law, the adoption of an expenditure framework for the oil fund, and the empowerment of the oil fund's supervisory council.
- Azerbaijan faces presidential elections this October. The country has not yet had a succession of leaders, and elections and referenda to date have been deemed problematic by the OSCE. Freedom to select their leaders is the most basic form by which citizens of Azerbaijan can demand budget accountability.

Cut to page 6:

Take a look at this table comparing the trend in output across a range of manufacturing and in oil extraction. While oil extraction increased, every other item declined sharply.

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- Kazakhstan also has done a good job of restoring macroeconomic stability and economic growth. It has an advantage over Azerbaijan in that oil and gas reserves are expected to last at least until mid-century, and Kazakhstan has not experienced the poverty and displacement that appear in Azerbaijan.

Nevertheless, significant challenges remain.

- The first is extreme regional disparities. Although Kazakhstan has among the highest average wages among the CIS countries, it also has one of the highest regional disparities among all transition economies. For example, Mangistau oblast, where a large oil field is located, has unemployment levels of 87%.

- For this reason, Kazakhstan must decide what its oil fund, which now holds over \$2.3 billion, will be used for. Currently it is being held in trust for the future. Many economists feel that with the country's current development needs, a portion should be used in rebuilding domestic infrastructure.

- There are also opportunities for improved fiscal transparency. Contracts for development of Kazakhstan's oil and gas have not been made public, as has been done in Azerbaijan. Energy companies provide no reporting on annual payments to the government. The oil fund lies outside of the budgetary process, and no annual reports or audits of the oil fund have yet been made public.

Moreover, Kazakhstan is now in the process of creating several new off-budget development funds, and the mechanisms for ensuring their transparency and accountability are not yet apparent. As a first step, we hope that Kazakhstan will join the table at the Extractive Industries Transparency Initiative.

- There are also opportunities for improving the enabling environment for civil society to act as budget watchdogs. The independent press has become marginal in Kazakhstan and many members of the opposition have been jailed or are in exile. Without an environment that permits free expression budget watchdogs cannot operate. As a first step, we hope that Kazakhstan would consider adopting a freedom of information law.

Let me conclude by saying that the governments of Azerbaijan and Kazakhstan are aware of many of these challenges and have taken positive steps. They have created oil funds and refrained from large spending sprees. They have restored macroeconomic stability. But to ensure that this limited opportunity of converting natural resource wealth into sustainable economic development not be lost, more needs to be done. There need to be greater accountability mechanisms built into the two countries fiscal systems, and there need to be more opportunities for the public to be informed about and to participate in budget oversight. I look forward to discussing with you how this can be achieved.