

Mineral-Rich Countries and Dutch Disease:  
Understanding the Macroeconomic  
Implications of Windfalls and the  
Development Prospects

The Case of Equatorial Guinea

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## Abstract

Referring to the original context of Dutch Disease, the term refers to the fears of de-industrialization that gripped the Netherlands as a result of the appreciation of the Dutch currency that followed the discovery of natural gas deposits. Expansion of petroleum exports in the 1960s not only crowded out other exports, it actually reduced other exports disproportionately and fueled the fears of dire consequences for Dutch manufacturing.

In the case of Equatorial Guinea, the secondary sector represents about 2 percent of the gross domestic product, manufacturing represents less than 1 percent, and oil represents more than 95 percent. The negative impact of the Dutch Disease in this context would be limited given the structure of the economy and on the contrary may even be a good thing because it fuels the structural transformational process of the economy, which is needed in Equatorial Guinea. This paper argues that the ongoing

Dutch Disease is a natural and necessary reallocation of resources in the economy of Equatorial Guinea.

The magnitude of negative macroeconomic consequences of the Dutch Disease depends on the country's economic structure and stage of development. In a country where the manufacturing sector barely exists or where the non-oil primary sector is structurally deficient, as has been the case of Equatorial Guinea, there is little to fear about the disease. The oil boom is a blessing, given that oil revenues when properly managed can play a special and critical role in overall economic development and poverty reduction in low-income countries. To promote good governance in the management of the country's oil wealth, the government may wish to adhere to clear standards of accountability and transparency; especially by complying with the Extractive Industries Transparency Initiative (EITI++).

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This paper—Poverty Reduction and Economic Management Division, Africa Region, Economic Management Department—is part of a larger effort in the department to help African Countries, manage and transform their natural resource wealth into long-term economic growth that spreads the benefits more fairly among their people for an effective poverty reduction. Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. The author may be contacted at [Atotosame@worldbank.org](mailto:Atotosame@worldbank.org).

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## I. Introduction

Equatorial Guinea<sup>1</sup> is a tiny country of 28,000 km<sup>2</sup> with a relatively small population estimated at about 506,000 inhabitants<sup>2</sup> and consists of several geographically distinct areas. Rio Muni, the mainland region, accounts for approximately 85 percent of the land area and 80 percent of the total population. The rest of the country includes the island of Bioko, which is the site of the capital city, Malabo, and five additional small islands in the Gulf of Guinea. Oil production began in 1992, with a production of 6,000 barrels a day, when an independent oil company, Walter International, started operations in the Alba field, situated 36 kilometers off the coast of Bioko; the larger Zafiro field, operated by Mobil Oil, came on stream in August 1996. Petroleum output average 83,000 barrels per day in 1988 representing more than 60 percent of GDP and reached a milestone of 400,000 barrels a day in 2005, about 90 percent of GDP.

Since Adam Smith and David Ricardo there has been a belief that natural resources are “a blessing”; therefore, countries richly endowed with natural resources have an advantage over countries that are not. Natural resource endowments have helped many countries (Norway, Malaysia, Botswana, Finland and Indonesia) to grow and diversify, in part by providing a basis for developing associated technologies and capital goods industries.

The abundance of natural resources also carries a paradox that has inspired innumerable studies of mineral-rich countries in the developing world. Since the 1970s they have consistently underperformed their mineral-poor counterparts on a variety of economic performance, good governance and income equality (Eifert, Gelb and Nils 2002); (Gelb1998); (Sachs and Warner 1997); (Auty 1998, 2001): this phenomenon has come to be known as the resource curse. The “resource curse” is the phenomena whereby a country with an export-driven, natural resources sector, generating large revenues for government, leads paradoxically to economic stagnation and political instability. There is considerable evidence that non-renewable natural resource revenues, especially windfall can, if not properly managed, adversely affect economic growth and poverty reduction.

The large-scale production of hydrocarbon in Equatorial Guinea has set the stage for a significant and dynamic structural transformation of its economy. The objective of this paper is to propose a medium and long-term strategy for managing the country’s rapidly rising oil wealth; ensure that the large oil endowment relatively to the size of the population is being translated into economic opportunities and benefices for the overall economy. We also argue in this paper that the ongoing Dutch Disease is a natural and necessary reallocation of resources within the Equatorial Guinea economy.

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<sup>1</sup>I am grateful to Rafael Munoz Moreno for his comments and suggestions; nevertheless, I am responsible for all errors or misunderstandings the document might contain.

<sup>2</sup>World Development Indicator Report (WDI) - The World Bank 2005.

## **II. Country Background until the Onset of Oil**

Equatorial Guinea is facing an amazing challenge in the short-term which is striving for an efficient management of oil wealth for a sustained poverty reduction. The GoEG needs to address the public finance management (PFM) weaknesses and governance if the country is to take advantage of its unique opportunity to use the nonrenewable oil wealth to foster economic structural transformation and achieve sustained broad-based growth and poverty reduction. The government also needs to strengthen and pursue a disciplined fiscal policy, make efficient use of oil revenue, implement a genuine budgetary control over expenditure commitments while providing provisions for priority sectors critical for the development process and poverty reduction (education, health and infrastructure).

### **A - Country Economic and Political Development Background until 1982**

During the 11 years following Equatorial Guinea's independence, the country was dominated by a dictatorship which devastated the economy and impoverished the population<sup>3</sup>. The economy was based almost exclusively on agriculture, fishing and forestry, accounting for 50 percent of GDP, about 97 percent of exports and the principal sources of income for about 80 percent of the population. Although well endowed with natural resources, Equatorial Guinea was characterized by a very weak public administration and a shortage of labor. In the 1970s, the economy was mismanaged, public administration ceased to function and the population survived at a barely subsistence level. A large part of the educated population was killed, approximately one-third of the population fled the country, and the formal education system ceased to function for about six or seven years (World Bank 1983a).

Cocoa, coffee and timber have traditionally been the country's main source of incomes. During the early period of independence, Equatorial Guinea experienced a drastic economic decline; GDP per capita in current terms fell sharply, from US\$ 260 in 1970 to about US\$ 170 in 1979, mainly because of the severe decline of the country's agricultural production. Cocoa exports fell from nearly 40,000 tons in 1968 to less than 20,000 tons at the beginning of the 1970s, following the departure of the foreign plantation owners and to about 7,000 tons a year after the exodus of some 30,000-40,000 Nigerian contract workers in the mid-1970s.

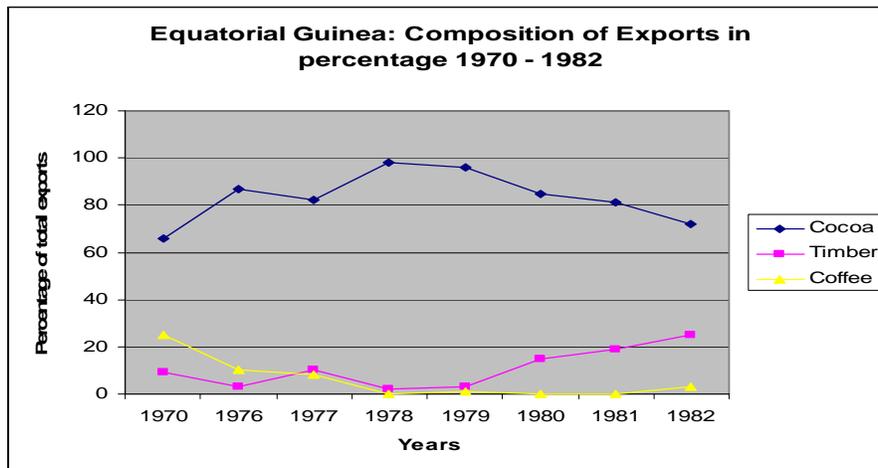
In an attempt to restore cocoa production, the government nationalized most plantations, introduced mandatory labor, and brought large numbers of people from the countryside to work on the state-owned plantations. However, poor public sector management, the inadequate and unmotivated labor supply, and reduced application of insecticides and fungicides led to a further decline in yields and in area cultivated.

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<sup>3</sup> Equatorial Guinea. An Introductory Economic Report – The World Bank, June 1983.

Exports<sup>4</sup> fell to a record low of 5,200 tons in 1980. When the government started seizing harvests without payment, cash crops were almost completely abandoned and barter trade became the dominant form of exchange.

Declines in the other agricultural sectors were equally striking; timber production declined from 360,000 cubic meters in 1968 to an annual average of 6,000 cubic meters in the late 1970s, and coffee and palm-oil production virtually disappeared. Basic services in health, education, water and electrical supplies could not be maintained; foreign investment literally stopped, and the trading system, operated by state enterprises, broke down.



Source: Equatoguinean authorities and World Bank.

The devastation of Equatorial Guinea's economy in the 1970s was accompanied by the complete disarray of its public finances. Public financial transactions were recorded only sporadically, and the accounts of the Treasury, the Bank of Equatorial Guinea - the former Central Bank – and public enterprises were not kept separately<sup>5</sup>. In August 1979, a military junta overthrew the dictatorship regime, led by Macias Nguema and established a new government, Presided by Lt. Col. Obiang Nguema Mbasoro and which then began to rebuild the economy and social institutions.

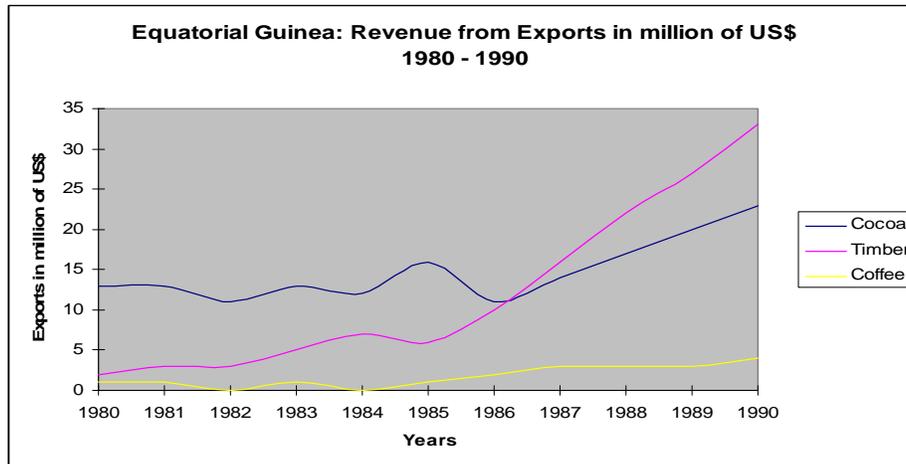
The new government reintroduced regular budgetary and banking procedures with technical assistance from IMF, and in April 1980, the first formal budget since 1974 was enacted followed by a stabilization program, agreed upon with the IMF, aimed at establishing financial discipline. During the first years of its rule, the government concentrated on returning the country to political stability, re-establishing the legal and administrative framework needed to support the economic reconstruction process, and attracting and coordinating the expected foreign aid. Rebuilding ministries and public agencies has been a difficult and a slow process though.

<sup>4</sup> The World Bank - Technical Assistance Project – Republic of Equatorial Guinea - May 1984.

<sup>5</sup> The World Bank – Report No P-4288 – EG, April 1986.

## B - Equatorial Guinea's Economic Management until the Onset of Oil (1982 - 1995)

The Government of Equatorial Guinea was confronted with two equally important issues which are: (i) to create favorable conditions for raising food and cash crop production and increasing exports, and (ii) to rebuild the public administration and social institutions needed to support the country's reconstruction.



Source: Equatoguinean authorities and World Bank

Private sector involvement was slow and hesitant in the reconstruction process given the shortage of local entrepreneurs and the weakness and inconvertibility of the domestic currency. In that context, most economic activities remained under governmental control. The rehabilitation of the cocoa sector was slow because both domestic and foreign labor showed little interest in working there, because of the combination of the experience with forced labor under the former regime and inadequate economic incentives.

In an effort to attract foreign aid, the government presented a three year reconstruction program 1982-1984 to an International Donor conference in April 1982. The program identified agriculture and infrastructure as the main development priorities, and several donors expressed interest in financing projects. In addition, given the weak public administration and the limited capacity, the government decided to transfer responsibilities for some key sectors - petroleum and forestry - of the economy from the Ministries concerned to the presidency in order to centralize the decision-making process, minimize coordination problems, and to efficiently allocate the limited existing skills. This new economic program was not sustained.

In 1985, Equatorial Guinea became a member of the Bank of Central African States (BEAC). Efforts to rebuild the economy were renewed, but overall growth was marginal; although timber production increased appreciably and activity in the commerce and trade sectors expanded, the production and export of cocoa, the country's main foreign exchange earning, stagnated far below levels achieved before independence and

worsening terms of trade contributed to large and unsustainable fiscal and external imbalance.

In 1988, the government adopted its first medium-term adjustment program covering the period 1988-1991. This program was supported by: (i) a first annual arrangement under the IMF's structural adjustment facility (SAF); (ii) a rehabilitation import credit (RIC) and sectoral loans from IDA; and, (iii) assistance from other international and bilateral donors. However, during 1988-1989, economic performance fell short of what had been envisaged under the adjustment program. Many of the program's objectives were not met owing to slippage in policy implementation, caused in part by limited administration capacity and by the continued erosion in world market prices of cocoa and coffee. After having grown by about 2.5% in 1986-1997, real GDP growth slowed to an average of less than 2% in 1988-1989, as production and exports of timber and cocoa declined.

In 1990 -1991, the government took a number of important steps to bring the structural adjustment program back on track. The reforms consisted mainly of efforts to diversify economic activity and to strengthen the production sectors, especially by (i) launching in October 1990, of a IDA-financed project to diversify agriculture in favor of food crops and non-traditional exports; (ii) the adoption of forestry action plan aimed at revitalizing production and exports, while strengthening the management and conservation of the country's natural resources and more notably; (iii) the signing, in April 1990, of a new contract with a foreign company to start the exploitation of the country's oil resources.

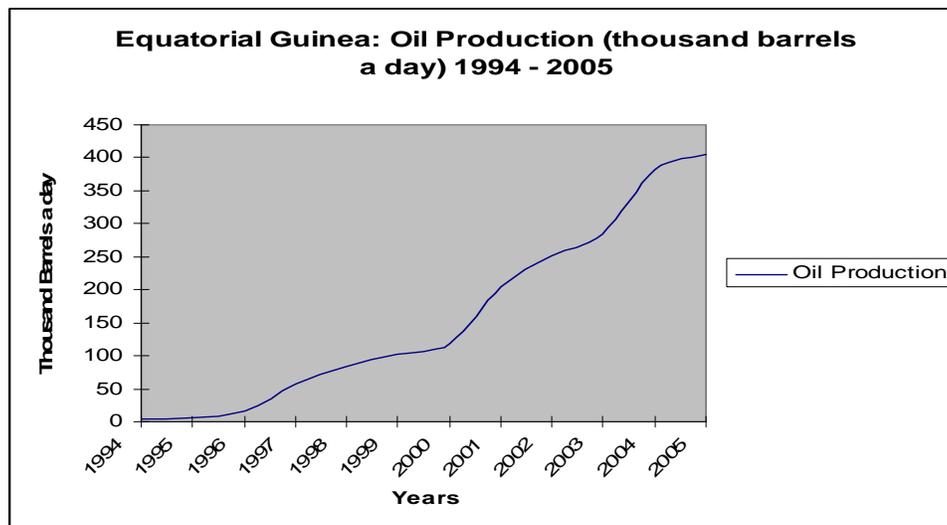
Export of oil started in April 1992 with petroleum production<sup>6</sup> estimated at 6,000 barrels per day in 1992. According to the terms of oil contract, total oil revenues accruing to the government from 1992 to 1994 was to be about US\$10 millions. Oil revenues were expected to increase substantially afterwards, especially from 1996 when profit sharing was to start and the government was set to receive some US\$60 to 90 million, on a cumulative basis, during the period 1995-2000.

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<sup>6</sup> Republic of Equatorial Guinea - Second Petroleum Technical Assistance Project - The World Bank, June 1992.

### III. Recent Economic Developments

Equatorial Guinea's economic developments<sup>7</sup> in the 1990s were dominated by the coming on stream of important oil fields in 1996; breaking with a long period of economic stagnation, real GDP growth<sup>8</sup> averaged 8.5 percent a year in 1992-1995, rose to 29 percent in 1996 and 71 percent in 1997 and was about 38.8 percent in 1999. Non-oil GDP grew by 10.3 percent on average in 1994-97 but remained flat in 1998 because of a downturn in timber output. Following the initial surge in prices in the wake of the devaluation<sup>9</sup>, inflation fell to 4.5 percent in 1996 on a year-end basis and 3.7% in 1997. Due to the development of the important Zafiro offshore oil field, investment rebounded, averaging 79 percent of GDP in 1994-98, while the national savings rate remained at 11 percent of GDP on average. In this context, the external current account deficit increased sharply from 56 percent of GDP to 103.5 percent in 1996 and 82 percent in 1998.



Source: Equatoguinean authorities.

Equatorial Guinea's fiscal management has become substantially expansionary with primary expenditure rising by 53 percentage points of non-oil GDP between 1994 and 1998 to 69 percent of non-oil GDP, including large unrecorded extra-budgetary expenditure financed through advances made by the oil companies at nonconcessional terms. In spite of an increase in government revenue of more than 10 percent points of GDP to 28 percent of GDP<sup>10</sup> over the same period, the primary budget balance, excluding foreign-financed investment, turned from a surplus of 4.5 percent GDP in 1994

<sup>7</sup> The coming on stream of important new oil fields in August 1996 led to a rapid transformation of Equatorial Guinea's economy, with the contribution of oil production to GDP at market prices growing from 18 percent in 1994 to 61 percent in 1998.

<sup>8</sup> In percentage change – IMF Staff country report No. 99/113 and No 03/385.

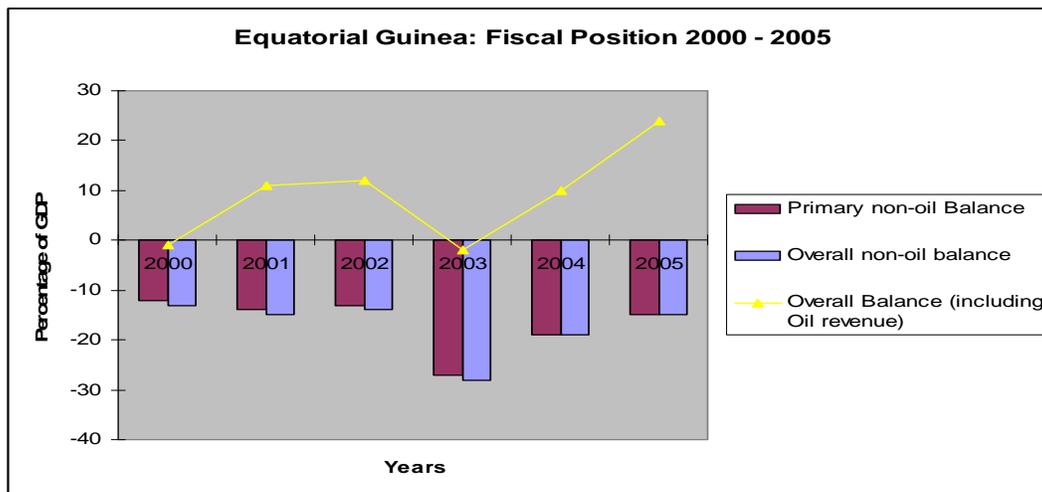
<sup>9</sup> The January 1994 devaluation of the CFA franc, fueled an upturn in the non-oil sector, led by intensification in logging activity that resulted in an unsustainable level of timber output in 1997.

<sup>10</sup> Equatorial Guinea: Recent Economic Developments. IMF Staff Country Report No 99/113, October 1999.

to a deficit of 1.4 percent of GDP in 1996. Oil revenue was generally higher than expected, however primary expenditure also exceeded budgetary allocations by very large margin, including large unrecorded extra-budgetary spending.

Oil revenue increased from below CFAF 2 billion in 1994 about 12 percent of oil export proceeds to CFAF 31 billion in 1998 around 13 percent of oil export proceeds. The ratio of government oil revenue to oil exports was small, as the production-sharing contracts initially signed by Equatorial Guinea were based on model contracts from a 1981 petroleum law designed to attract investors to an underdeveloped area with uncertain oil prospects.

In 1998, the government succeeded in renegotiating the Mobil contract. The most significant changes were (i) an increase in the royalty rate from the initial flat rate of 10 percent of gross revenues to a sliding scale ranging from 12 percent to 16 percent, (ii) the imposition of limits on cost deductions of an annual maximum of 80 percent of gross export proceeds, (iii) a reduction in the uplift rate (margin added to cost carried forward) from 30 percent to 19 percent, and (iv) the assignment to the government of 5 percent share in equity. The increase in the royalty rate had an immediate positive impact on the government oil revenue, which increased to CFAF 53 billion in 1998, about 20 percent of oil export proceeds.

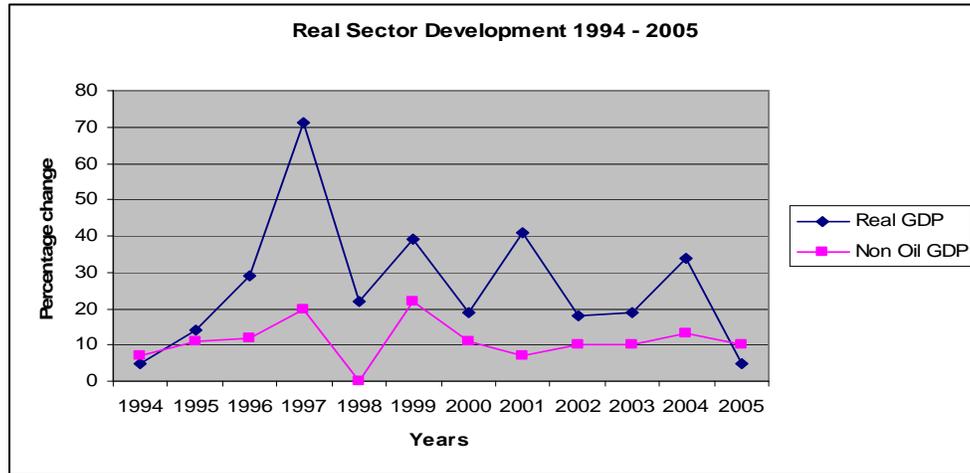


Source: IMF; Equatoguinean authorities.

Macroeconomic developments<sup>11</sup> continued to be dominated by the hydrocarbon sector, with oil and gas accounting for about 90 percent of GDP, 98 percent of exports and over 90 percent of government revenues. Real GDP grew by about 34 percent in 2004, driven by the sharp expansion in hydrocarbon production. Non-oil GDP increased by about 13 percent, owing to continued strong performance in the construction, infrastructure and service sectors simulated by government spending. In 2005 due to a slowdown in hydrocarbon production, the overall GDP growth decelerated sharply. Large

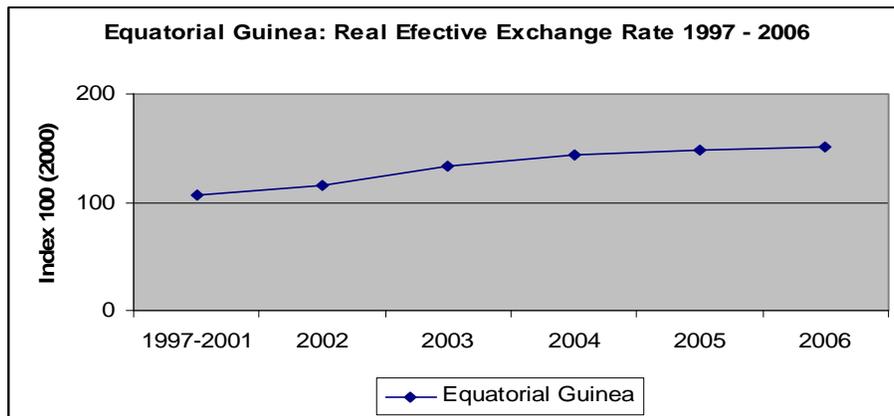
<sup>11</sup> IMF – Republic of Equatorial Guinea: 2005 and 2006 Article IV Consultations.

public infrastructure investment and private housing construction continued to be the main sources of growth in the non-oil GDP.



Source: Equatoguinean authorities; and IMF.

The real effective exchange<sup>12</sup> rate of the CFA franc calculated for Equatorial Guinea continued to appreciate during 2005. This pattern largely reflected the appreciation vis-à-vis the U.S. dollar and the persistent large inflation differential with the major trading partner countries: in fact these are evidences of Dutch Disease. The appreciation of the real exchange rate for Equatorial Guinea was the largest in the CEMAC region, reflecting the country's position as the largest oil exporter and recipient of foreign direct investment relative to GDP.



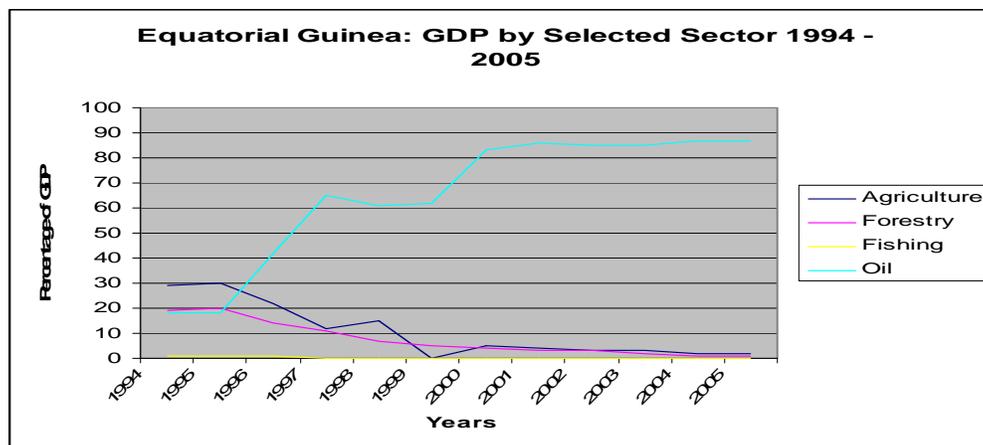
Sources: Equato-Guinean authorities Bank and Fund staff estimates.

The traditional exports stagnated during the last few years; because producers' profits were adversely affected by the nominal appreciation of the CFA franc vis-à-vis the U.S. dollar. However, another crucial underlying factor for stagnation in traditional

<sup>12</sup> Overall movement in the real effective exchange rate appeared to be dominated by the response to favorable terms of trade developments particularly world oil prices and other fundamentals, such as the strong overall fiscal position.

exports was the loss of immigrant farm labor<sup>13</sup>, which was exacerbated by the abandonment of the farms in search of more lucrative employment in the oil and related sectors and, the poor yields of aged plantations.

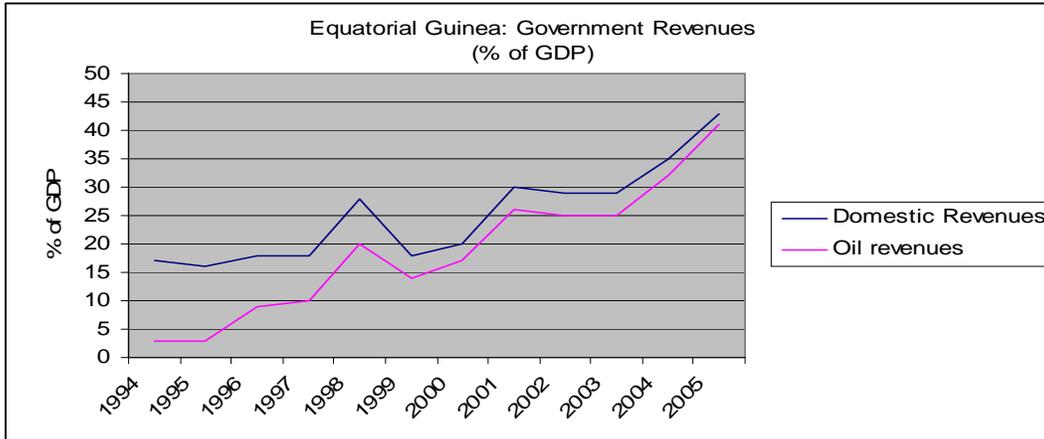
The traditional export sectors which has always been in difficulty given the recurrent shortage of labor, is further affected by the real exchange rate appreciation, consequence of favorable terms of trade developments particularly world oil prices and other fundamentals, such as the strong overall fiscal position which itself is good for the overall economy; given the current structure of Equatorial Guinea economy. The appreciation of the real exchange rate is likely to accelerate the shifting of production inputs (*capital and labor - resource movement effect*). The Dutch Disease, by reallocating resource may be doing what the government would have been otherwise reluctant to do, therefore facilitating the transformational process of the economy.



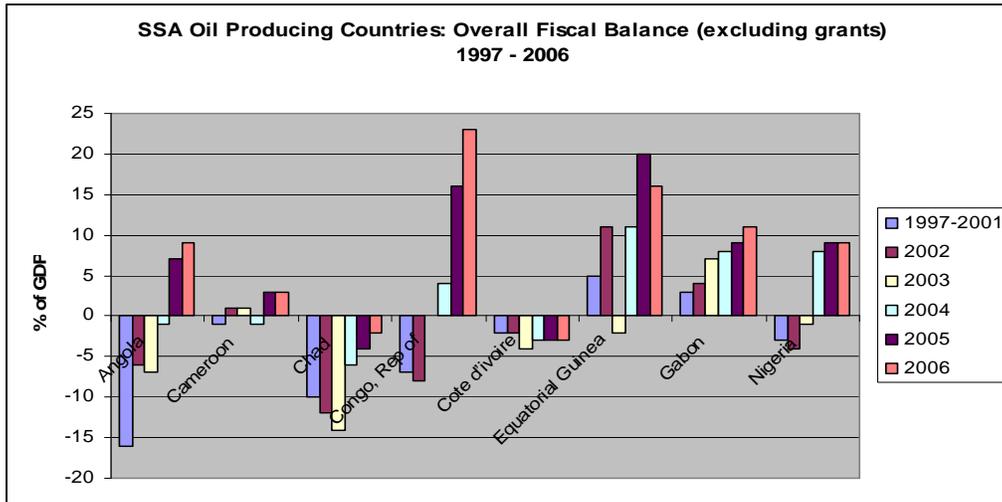
Source: Equatoguinean authorities and IMF.

Despite the enormous resources derived from oil exports which have increased the per capita GDP from US\$ 346 in 1995 to US\$ 3391 in 2004, Equatorial Guinea has not yet been able to significantly improve living conditions of the majority of the population. Sixty-six percent of the population still does not have access to potable water and the illiteracy rate stands at 60 percent. Infant mortality is about 97/1,000. The 2005 UNDP Human Development Index ranked the country 121<sup>st</sup> over 177 countries for which the index has been calculated. This poor performance reflects the absence of a comprehensive development and poverty reduction framework as well as poor human resource capacity which impedes the translation of the main policy objectives of the government into a set of budget priorities and expenditures.

<sup>13</sup> Indeed, there is continued shortage of labor in EQG.



Source: Equatoguinean authorities



Sources: IMF, African Department database, March 2007; and World Economic Outlook 2007.

#### **IV. Understanding the Macroeconomic Implications of the Windfalls and Development Prospects**

Since Adam Smith and David Ricardo there has been a belief that natural resources are “a blessing”; therefore, countries richly endowed with natural resources have an advantage over countries that are not. Natural resource endowments have helped many countries (Norway, Malaysia, Botswana, Finland and Indonesia) to grow and diversify, in part by providing a basis for developing associated technologies and capital goods industries.

The abundance of natural resources also carries a paradox that has inspired innumerable studies of mineral-rich countries in the developing world. Since the 1970s they have consistently underperformed their mineral-poor counterparts on a variety of economic performance, good governance and income equality (Eifert, Gelb and Nils 2002); (Gelb 1998); (Sachs and Warner 1997); (Auty 1998, 2001): this phenomenon has come to be known as the resource curse. The “resource curse” is the phenomena whereby a country with an export-driven, natural resources sector, generating large revenues for government, leads paradoxically to economic stagnation and political instability. There is considerable evidence that non-renewable natural resource revenues, especially windfall can, if not properly managed, adversely affect economic growth and poverty reduction.

The weak economic performance and continued poverty in many oil-exporting countries, continues to pose a challenge to scholars and development practitioners. The abundant literature explaining the poor growth performance in resource-rich-countries<sup>14</sup> can be divided in two set of issues which are as follows: some focus on the economic effects namely Dutch Disease and volatility known as booms and busts (Gelb 1988); Rigobon (2003); (Auty 2001) other focus on governance issues (Karl 1970); (Eifert, Gelb and Tallroth 2002). Understanding these two features of resource curse is critical for Equatorial Guinea if it is to make its exceptional oil wealth a blessing rather than a curse.

The most prevalent cause attributed to poor rates of economic growth in mineral-rich countries is Dutch Disease; a term originally referring to the problems the Netherlands encountered when it discovered huge gas reserves off its northern coast in 1959. The Netherlands experienced then a vast increase in its wealth after discovering large natural gas deposits in the North Sea. Unexpectedly, this sudden ostensibly positive development had had serious negative repercussions on important other segment of the economy, as the Dutch currency became stronger, hence making Dutch non-oil exports less competitive. This adverse impact is known as *Dutch Disease*.

The mechanism of a paradox negative impact of a sudden wealth on the economy can be described as follows: an economy experiencing an export boom can be divided into three sectors which are (i) the booming export sector; (ii) the lagging export sector –

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<sup>14</sup> Sachs and Warner, 1997 from a sample of 95 developing countries found a clear negative relationship between natural resource based exports and growth in the period 1970-90.

traditional exports - as the two traded goods sectors and (iii) the non-traded goods sector, which essentially supplies domestic resident and might include retails trade, services and construction. In the presence of Dutch Disease, the traditional export sector gets crowded out by the other two sectors (Corden and Neary in 1982).

Generally the windfalls lead to an appreciation of the real exchange rate by shifting production inputs (capital and labor) to the booming mineral sector and non-tradable sector (retail trade, service, and construction), thereby reducing the competitiveness of the non-booming sector mostly agriculture and manufacturing<sup>15</sup> hence participating in their collapse. The shift into non-tradable sector accelerates domestic inflation<sup>16</sup>, which is responsible for the real exchange rate appreciation. These short-term macro-adjustment problems result in long-term effects on growth by reducing the country's economic diversity and increasing its reliance on exports from its natural resource sector.

The phenomenon of Dutch Disease is already affecting the economy of Equatorial Guinea<sup>17</sup>. The real effective exchange rate for Equatorial Guinea was the largest in the FCFA zone oil-exporting countries<sup>18</sup>. However, we argue in this paper that the ongoing Dutch Disease is a natural and necessary reallocation of resources within the Equatorial Guinea economy, despite the negative impact of real effective exchange rate appreciation on Equatorial Guinea's economy<sup>19</sup>. In fact the real effective exchange rate of the CFA franc calculated for Equatorial Guinea continued to appreciate during 2005 and 2006. This pattern largely reflected the appreciation vis-à-vis the U.S. dollar and the persistent large inflation differential with the major trading partner countries. The appreciation of the real exchange rate for Equatorial Guinea was the largest in the CEMAC region, reflecting the country's position as the largest oil exporter and recipient of foreign direct investment relative to GDP.

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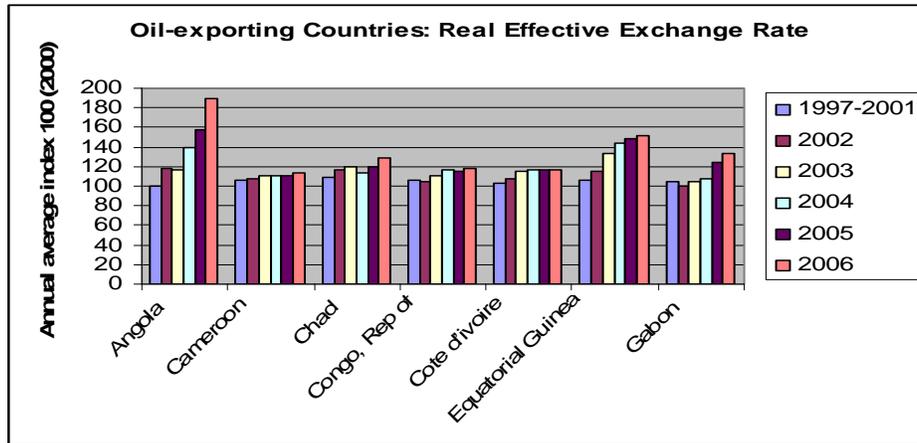
<sup>15</sup> Equatorial Guinea does not have a structured manufacturing sector therefore the real exchange rate appreciation makes the imported goods on which the country depends on cheaper.

<sup>16</sup> As the matter of fact, the non-tradable sector supply is inelastic in the short term so, when demand expands and resources move into the non-tradable sector, this causes prices to increase thereby induces real exchange rate appreciation.

<sup>17</sup> In the sense that, the natural resource boom raises the value of the domestic currency and led to, increasing imports and decreasing traditional export sector.

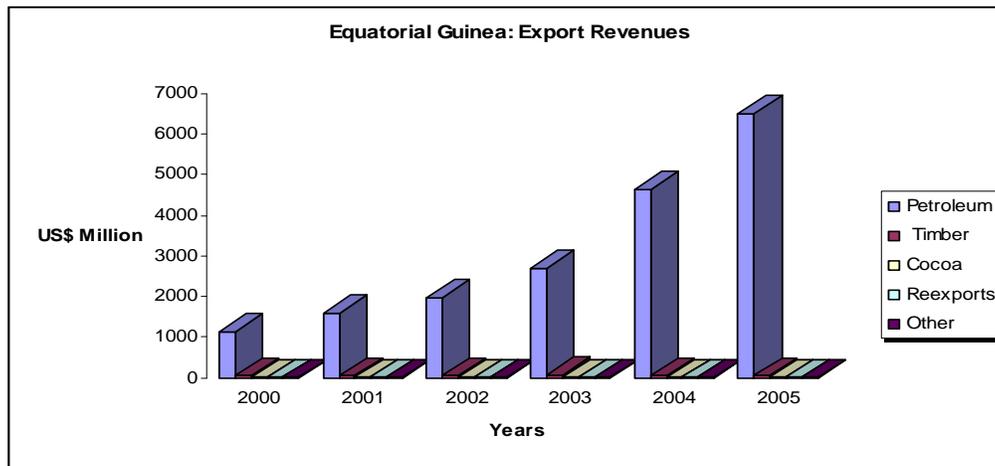
<sup>18</sup> Angola is not part of the FCFA zone currency arrangement.

<sup>19</sup> Having said that it is noteworthy to emphasize that there is no risk of deindustrialization, given the structure of Equatorial Guinea Economy; and neither the risk of making manufactured goods less competitive simply because the manufacturing sector does barely exist to say the least.



Source: IMF, African Department database, March 2007.

The traditional exports stagnated during the last few years; because producers' profits were adversely affected by the nominal appreciation of the CFA franc vis-à-vis the U.S. dollar. However, another crucial underlying factor for stagnation in traditional exports was the loss of immigrant farm labor<sup>20</sup>, which was exacerbated by the abandonment of the farms in search of more lucrative employment in the oil and related sectors and, the poor yields of aged plantations.



Source: Equatoguinean authorities

The traditional export sector which has often been in difficulty due to the recurrent shortage of labor, is obviously further affected by the real effective exchange rate appreciation, consequence<sup>21</sup> of favorable terms of trade developments particularly world oil prices and other fundamentals, such as the strong overall fiscal position which itself is good for the overall economy; given the current structure of Equatorial Guinea economy, and the importance of the oil sector and the real effective exchange rate appreciation for Equatorial Guinea, the Dutch Disease is likely to accelerate the shifting

<sup>20</sup> Indeed, there is continued shortage of labor in EQG.

<sup>21</sup> Among other things; the noticeable persistent large inflation differential with the major trading partner countries.

of production inputs (*capital and labor - resource movement effect*) and therefore permanently crowds out the declining<sup>22</sup> traditional export sector by the other two booming sectors of the economy. The Dutch Disease, by reallocating resource may be doing what the government would have been otherwise reluctant to do, therefore facilitating the transformational process of the economy.

Going back to the original context of Dutch Disease, the term refers to the fears of de-industrialization that gripped the Netherlands as a result of the appreciation of the Dutch currency that followed the discovery of natural gas deposits. The appreciation of the Dutch currency that followed the gas export boom reduced the profitability of manufacturing and service exports<sup>23</sup>. Total exports decreased markedly to GDP during the 1960s. Expansion of petroleum exports in the 1960s not only crowded out other exports, actually reduced other exports disproportionately and fueled the fears of dire consequences for Dutch manufacturing.

In principle the Dutch Disease<sup>24</sup> can be seen as a matter of one sector benefiting partly at the expense of others therefore not an impediment *per se*; however the disease is potentially harmful if there is something special about the reallocation of resources between sectors; for example from high-tech service industries to low primary production (Gylfason 2001). The oil boom would therefore induce a decline in a technologically leading sector of the economy with adverse consequence for long-term growth: The resource shift can then become a true disease (Sachs 2007).

In the case of Equatorial Guinea the secondary sector represents about 2 percent of the GDP and the manufacturing almost does not exist; in average from 2000 to 2005 the manufacturing sector represented less than 1 percent of GDP. The negative impact of Dutch Disease in that sense will be limited<sup>25</sup> given the structure of the economy and on the contrary may even be a good thing in that context, because it fuels the structural transformational process of the economy which was needed in Equatorial Guinea.

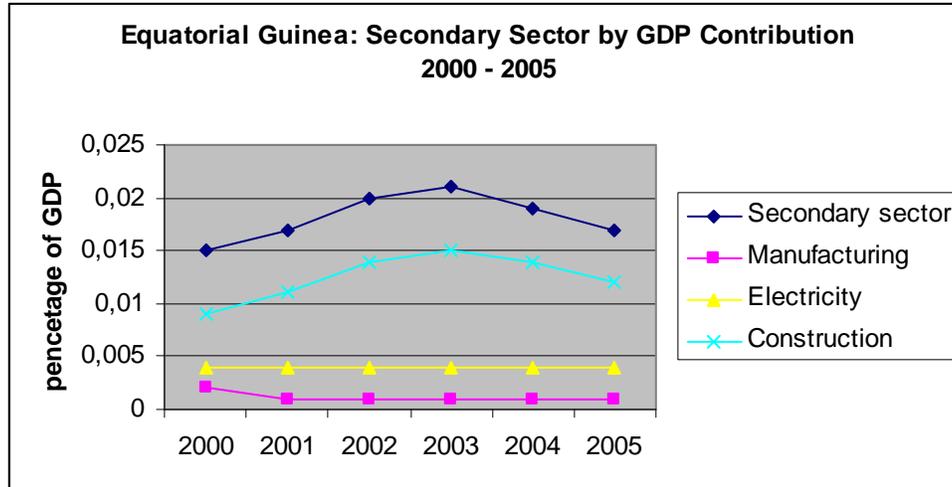
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<sup>22</sup> The Traditional export sector has been in difficulties for years even before the coming on stream of important oil fields due to structural deficiencies and mostly labor.

<sup>23</sup> Thorvaldur Gylfason. Lessons from the Dutch Disease: Causes, Treatment, and Cures - Institute of Economic Studies - University of Iceland. August 2001.

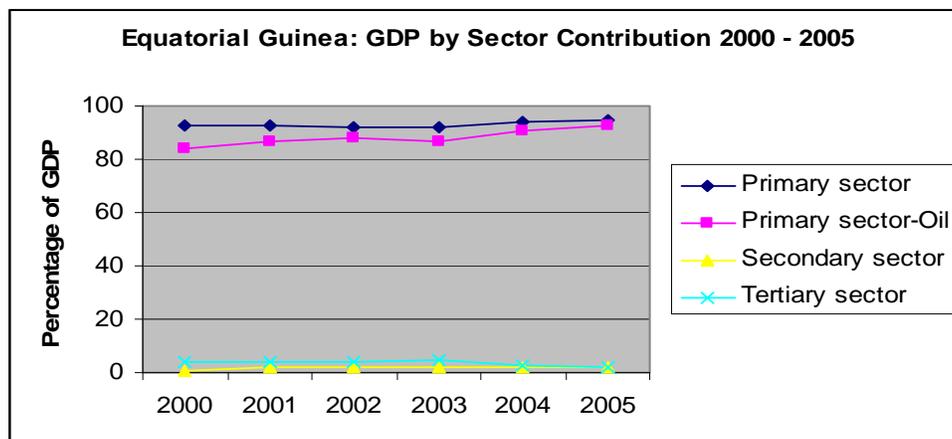
<sup>24</sup> The Dutch disease is a matter of concerns mainly because of its potentially deleterious consequence for economic growth.

<sup>25</sup> Apart from the domestic food production: the real exchange rate appreciation has made imported foods cheaper hence; has increased the dependency on imported foods to the detriment of domestic food production sector. This short-term macro-adjustment consequent can be corrected through increased productivity and reallocation of resources in the sector.



Sources: Equato-Guinean authorities Bank and Fund staff estimates.

The magnitude of negative macroeconomic consequences of the Dutch Disease will depend on the country economic structure and the stage of development, hence will vary from country to country. A country where a manufacturing sector does barely exist or where the non-oil primary sector is structurally deficient as it has been the case of Equatorial Guinea; there is little to fear about the disease. In that context the oil boom become a blessing, given that oil revenues when properly managed, can play a special and critical role in overall economic development and poverty reduction in low-income countries like Equatorial Guinea. Although the GDP per capita has substantially increased from US\$ 346 in 1995 to US\$ 3391 in 2004 due to the coming on stream of important oil fields, EQG remains among the poorest country by the standard of living conditions and the level of development.



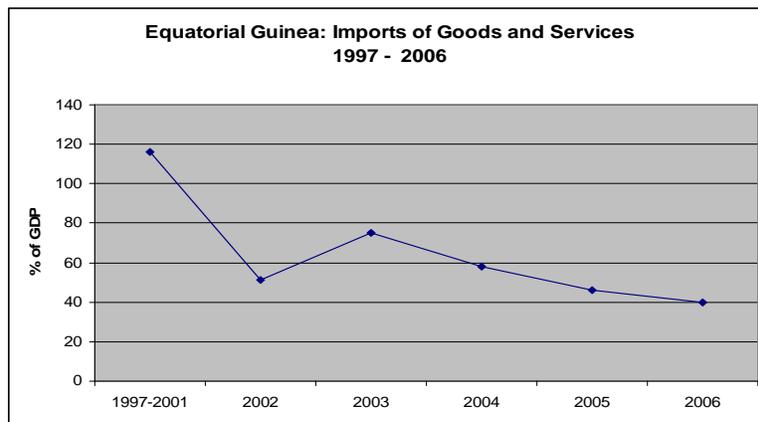
Sources: Equato-Guinean authorities Bank and Fund staff estimates.

Considering the pattern of EQG traditional agriculture and export sectors before the coming on stream of important oil fields in 1996, the sector was already in decline despite the government's efforts. Cocoa, coffee and timber have traditionally been the country's main source of income. During the early period of independence, Equatorial Guinea experienced a drastic economic decline; GDP per capita in current terms fell

sharply, from US\$ 260 in 1970 to about US\$ 170 in 1979, mainly because of the severe decline of the country's agricultural production.

As already mentioned the cocoa sector has been deficient, long before the coming on stream of important oil field and subsequent oil-revenues. Cocoa exports fell from nearly 40,000 tons in 1968 to less than 20,000 tons at the beginning of the 1970s, following the departure of the foreign plantation owners and to about 7,000 tons a year after the exodus of some 30,000-40,000 Nigerian contract workers in the mid-1970s. Decline in the other agricultural sectors was equally striking; timber production declined from 360,000 cubic meters in 1968 to an annual average of 6,000 cubic meters in the late 1970s, and coffee and palm-oil production virtually disappeared. Since then the sector has barely recovered, on the contrary, the labor's shortage remains persistent combined with the real effective exchange rate appreciation and the magnitude of oil resource, the very small traditional export sector seems not to be viable.

In addition Equatorial Guinea is a tiny country of 28,000 km<sup>2</sup> with a relatively small population estimated at about 506,000 inhabitants, therefore the traditional export sector cannot be significantly expanded<sup>26</sup> and the country does not have any specific comparative advantage in the traditional export sector. Continual mobilization of resources in the sector is costly because of the poor marginal return the sector can yield and in the same time it deprives the economy of critical resources needed to develop other strategic sectors, therefore constitutes a waste of resources. The traditional export sector will probably disappear due to the necessary ongoing reallocation of resources within the economy. The traditional export sector could then be substituted by the emergence of a competitive food production sector to warrant food security and limit the dependency on imported foods.



Source: Equatorial Guinean authorities Bank staff and IMF.

Natural resource endowment is a blessing if well utilized, to escape the poverty trap and a sound resource-led development strategy can make a difference, therefore it is

<sup>26</sup> Although the country can import labor; however the strategy consisting of importing labor has always been the main flaw of the system and likely to increasingly be the case given the new oil-based economy and its spillover effects.

important to understand the dynamic of structural changes that typically occur along with large-scale mineral production. In the context of an oil boom the structure of the economy is fundamentally transformed; these changes, together with the revenues from oil exports, could set the stage for a sustained growth and economic development. Before the large-scale oil production, Equatorial Guinea was among the poorest countries in the world, with a very weak economy; without oil production, the country future would have been extremely bleak<sup>27</sup>. Hence, Equatorial Guinea's oil windfall is virtually a blessing if well utilized<sup>28</sup>.

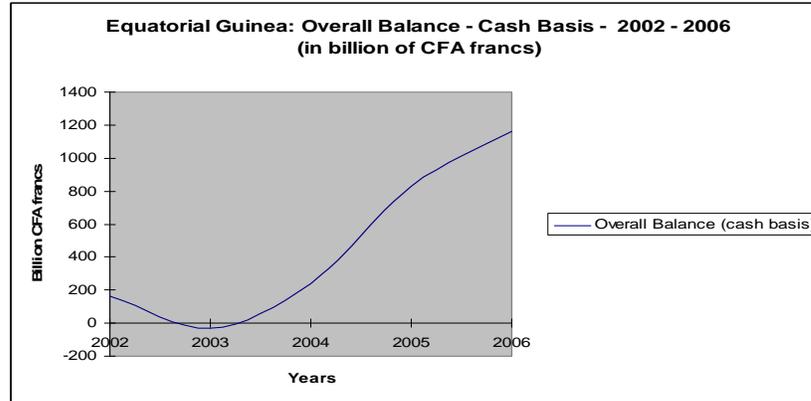
It is critically important for Equatorial Guinea authorities to reorient their resources and development efforts where the country could have proven comparative advantage; for example tourism and to develop other export niches and sectors of the economy which can generate as much as foreign exchange earnings than the traditional export sector. Food constitutes by far the largest single item of household consumption in general. Oil proceeds can also be invested in raising the productivity of farmers by financing improved seed variety for local production to support the transition from the traditional agricultural export sector to increase local food production. The tertiary sector globally needs the government's attention toward a service based economy supported by oil-revenues during the transitional period. This backdrop does not mean that the manufacturing sector should not exist on the contrary, the new-economy in the making will demand a different type of industries and manufacturing alongside the service based economy.

The Dutch Disease is a matter of concern mainly if the oil windfalls are used to finance private consumption rather than investment. In that case, the non-oil traded sector might well be squeezed on a sustained basis, with adverse consequences for long-term growth; it is very unlikely if the oil proceeds are properly used for public investments in an economy largely in need of basic infrastructure as is the case of Equatorial Guinea. Given the volatility of world oil prices and the depletion of oil over time, considerable care must be given to managing the large macroeconomic risks of oil income flows, as well as to spread the benefits of the oil earnings across generations through, mostly, long-lasting financial, physical, and human capital.

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<sup>27</sup> The country like many SSA countries was not creditworthy, and therefore could not borrow the needed investment funding from private capital markets for public investments, in addition the economy was not able to generate substantial income; in other word the country was in a poverty trap. Oil proceeds in principle allow countries to break out of the poverty trap.

<sup>28</sup> The proceeds of the oil revenues should equally be invested in economic and social infrastructure that raises productivity of workers both in traded and not traded-sector for example in roads, power, telecoms, health and education.



Sources: Equatorial Guinean authorities Bank staff and IMF.

Another well-known issue of resource-rich economies is volatility, known as *boom and bust cycles*, which can equally have negative impact on economic growth. This phenomenon plagues oil exporter<sup>29</sup> countries, given the importance of oil in the overall economy and in government revenues. The economic impact includes unpredictable revenue streams because widely fluctuating export revenues lead to fluctuating levels in overall government revenues (Mikesell 1997). These frequent upward or downward adjustments of fiscal expenditures are costly because they simultaneously discourage private investment and destabilize the government's budget, therefore impeding its ability to sustain investment and social provision and service deliveries (Katz et al. 2004). In addition, once expenditures become entrenched, it is harder for governments to make budget cuts; rather than reversing their spending patterns during busts, they often opt to borrow, and hence, risk incurring huge debt burdens.

A country with large revenues derived from exploiting a nonrenewable resource such as oil, typically faces two main problems: (i) the revenue stream is uncertain and volatile because it depends on the world oil prices, and (ii) that revenue will eventually dry up. Nonrenewable Resource Funds (NRFs) are proposed to deal with both problems. First, a fund may be seen as able to stabilize budgetary revenues. When oil price is high, the fund would receive excess resources, which would then allocate to the budget when the price is low and therefore revenues. Second, a fund may be seen as a way to save some of the revenue generated by exploiting the finite stock of the resource, which can then provide income after it has been depleted. Funds may also be set up for other reasons such as to counteract the spending effect leading to the real exchange rate volatility and Dutch Disease, for liquidity and political economy purposes, and to enhance governance and transparency (Jeffrey Davis et al. 2001).

Norway, for example, has charted a long-run-oriented, tax-based and reasonably market friendly approach to the management of its oil resources. The oil revenue is deposited in the Norwegian Petroleum Fund, which is being built up and invested mostly in foreign securities for the benefit of the current generation of Norwegians when they reach old age as well as for the future generations, and also in order to shield the

<sup>29</sup> Although market volatility is a problem for all exporters of primary commodities, the phenomena is acute for oil exporting countries given the importance of oil in the overall economy.

domestic economy from overheating and possible waste. At the same time, however, a variable proportion of each year's net oil-tax revenue is transferred from the government's Petroleum Fund to the fiscal budget, essentially to cover the non-oil budget deficit<sup>30</sup>.

The Azerbaijan Republic also established an Oil fund. The State Oil Fund of the Republic of Azerbaijan (SOFAZ) was established in 1999 as an extra-budgetary institution. Its main objective is the management of oil and gas related revenues for the benefit of the country and its future generations. SOFAZ receives all government revenues associated with the post-Soviet oil and gas production fields. This oil fund has no immediate stabilization objective and net flows are not related to the oil prices level or a budgetary position. On the outflow side, Azerbaijan's oil fund rules currently prohibit spending in excess of inflows in any given year. A conservative expenditure policy has ensured a steady growth of savings in the fund. Asset management regulations require that financial assets be kept offshore at highly rated banks. The fund is not permitted to extend credits to private or state organization and assets cannot be used as a guarantee against any obligation<sup>31</sup>.

In order to reduce political pressures to spend windfall oil revenues rapidly, the government established the oil fund under direct Presidential control. The members of SOFAZ's supervisory board are appointed by the President of Azerbaijan. An independent auditor conducts an annual audit of the fund, and the audit report is made public. SOFAZ reports quarterly in the press on total inflows received, expenditure, and interest earned. To strengthen the legislative foundation of SOFAZ, its budget and asset management rules were approved by Parliament in June 2003 as amendments to the Budget System Law. The Creation of an oil fund in Azerbaijan has had a positive impact on fiscal discipline and contributed to better transparency and accountability of oil revenue management.

Jeffrey Davis et al in 2001 assessed the effectiveness of NRFs, by using both econometric evidence and country case studies; limitation on the availability and quality of the data, and the small sample, warrant caution in interpreting the results. The econometric evidence suggests that in some countries with NRFs, expenditure has tended to be less correlated with changes in nonresource export earnings than in those without funds, although this experience is not uniform. It also indicates, however that for countries with NRFs the establishment of a fund did not have an identifiable impact on government spending.

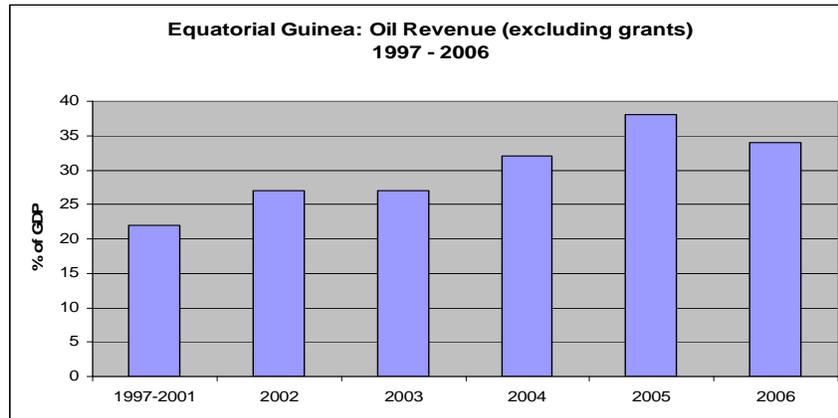
This finding may suggest that countries with more prudent expenditure policies tended to establish a NRF, rather than the NRF itself leading to increased expenditure restraint. It could, however, be argued that the establishment of a fund may have helped to maintain cautious policies in the context of ongoing revenue variability. In other hand, country experience suggests that the behavior of prices and the issue of fungibility pose

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<sup>30</sup> Thorvador Gylfason. The Paradox of Plenty – For the Statoil-Econ conference volume – Lessons from the Dutch Disease: Causes, Treatment, and Cures. March 2001.

<sup>31</sup> Managing the Oil Wealth: The Case of Azerbaijan. International Monetary Fund, 2004.

substantial problems for the operation of the NRFs. In several cases, the integration of the fund's operation with overall fiscal policy has proven problematic, and despite the operation of a fund, the stabilization of expenditure has been elusive. Moreover, there is evidence that funds may have been most difficult to operate when the extent of reliance on windfall has been important.



Source: Equatorial Guinea Authorities and Bank's staff and IMF.

Overall, natural resource endowment if well managed is a blessing rather than a curse for low-income countries to escape the poverty trap and a sound resource-led development strategy could make a difference. However a volatile and uncertain fiscal revenue source renders fiscal management, budgetary planning, and the efficient use of public resources difficult. This is the case particularly when it makes up a large share of total revenue as it is the case of Equatorial Guinea and suggests that the country should constantly follow a strict fiscal discipline to better manage increasing surpluses while promoting the development process. Hence it is critical to assess the policies, institutions and capacity for the management of Equatorial Guinea's oil dominated economy.

## **V. Assessment of the Oil Wealth Governance and the Country's PFM – Institutional Arrangements**

The phenomenon of Dutch Disease and boom and bust cycles are not the only mechanisms whereby economic growth is negatively affected by windfalls; probably, and almost equally important are the incentives that windfalls create for unproductive investments, rent-seeking and corruption. Many scholars and development practitioners argue that, because windfall rents are concentrated and easily obtained; they exert pressure to engage in rent-seeking, corruption and governments to share increased revenues with the public, often by investing in unproductive public work project or subsidizing food, fuel failing industries and even government jobs (Auty 1990); Gelb et al 1988) and (McMahon 1997). Therefore it is important to assess the oil wealth governance and PFM Institutional arrangements to increase transparency and accountability.

### **A - Assessment of the Oil Wealth Governance**

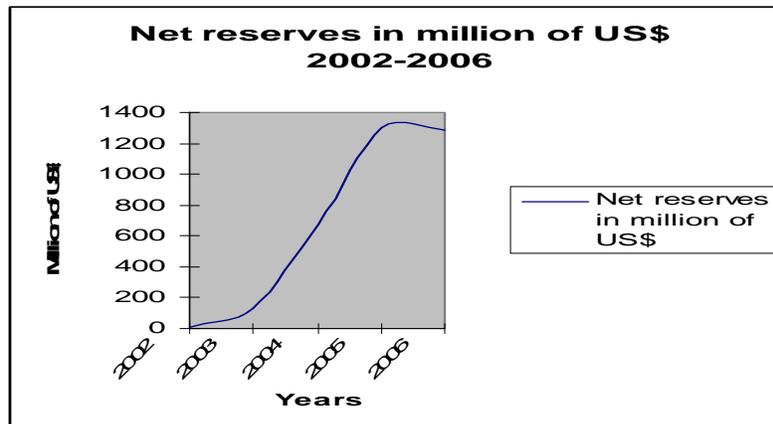
Since the onset of oil production in 1995, the hydrocarbon sector has been the engine of growth. The production has increased from 6,000 barrels a day to 282,000 barrels a day in 2003, supporting an average annual GDP growth of 31 percent. The production subsequently reached a milestone of 400,000 barrels a day in 2005 and accounted for over 90 percent of government revenues. This wealth is yet to be transformed in living conditions and poverty reduction, despite an increase in per capita GDP from US\$346 in 1995 to about US\$3391 in 2004, with a relative small population estimated at 506,000<sup>32</sup> inhabitants in 2004. A comprehensive medium-term strategy for managing the country's rapidly rising oil wealth is required to ensure that the large oil endowment relatively to the size of the population is being translated into benefits for the poor. To promote good governance in the management of the country's oil wealth, the government may wish to adhere to clear standards of accountability and transparency; especially by complying with the EITI.

Equatorial Guinea is currently the only African oil-producing country where oil revenue clearly exceeds the country's absorptive capacity and where sizable foreign assets have been accumulated (Katz et al. 2004). The widespread poverty and low human indicators in Equatorial Guinea argue for upgrading domestic infrastructure and increasing public services so as to improve the quality and productivity of physical and human capital. Investment in financial assets would build the reserves needed to gradually increase capital investment as absorptive capacity grows. The current fiscal rule, which the government is trying to follow, is to use non-oil revenue to finance current expenditures and oil revenue to finance capital expenditure, and to save what is left.

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<sup>32</sup> World Development Indicator Report (WDI) - The World Bank 2005.

Until 2001, when hydrocarbon revenue was first incorporated into the budget, fiscal surplus was held in treasury investment accounts abroad. The realism and accuracy of oil revenue projections improved with the revised budget for 2002, submitted to parliament in May 2002. As of that date the previous practice of extra-budgetary expenditure using advances from oil companies, has been discontinued. Equatorial Guinea now has a rule that allows hydrocarbon revenue to be used only to finance public investment. At present, the government holds the bulk of its foreign reserves in the regional central bank, BEAC. However, Equatorial Guinea authorities maintain foreign exchange accounts abroad, only the President has access to these accounts<sup>33</sup>.



Sources: Equatorial Guinea Authorities and IMF.

Authorities established a government-owned oil company as the National Oil Company of the Republic of Equatorial Guinea (GEPETROL), by Presidential Decree in February 2001, and the company became operational in 2002. The company was founded to improve the government's overall receipts through the negotiation of contracts, commercialization of royalties that are received in kind, and participation in production activities. Despite the limited capacity of the firm, so far negotiation of some contracts has been conducted, and the sale of some royalties received in kind has been tendered to commercial traders. The Ministry of Mines and Energy regulates and supervises GEPETROL, and the enterprise is instructed to use only government accounts for the deposit of revenue from activities.

GEPETROL manages the state's participation as a shareholder and other rights and obligation in Petroleum contracts; acts as agent for the sales of the state's share of Hydrocarbons. It is equally the state's agent for licensing open acreage within Equatorial Guinea. GEPETROL is mandated to participate in commercial ventures, either solely or as a partner with other national or foreign companies, within Equatorial Guinea or abroad. GEPETROL interacts with the Ministry of Mines, Industry and Energy on a regular basis to co-ordinate the affairs of the petroleum sector in Equatorial Guinea. The Ministry of Mines, Industry and Energy is the overall regulatory and administrative body

<sup>33</sup> The Government was considering in late 2006 the possibility of managing its hydrocarbon revenue through two funds: the Fund for Future Generations and the Special Reserve Fund.

for the petroleum industry in Equatorial Guinea. GEPETROL also participates in general commercial ventures that enhance economic development of Equatorial Guinea.

Based on Equatorial Guinea's hydrocarbons law the petroleum sector legal framework is transparent and precise vis-à-vis oil companies operating in Equatorial Guinea. The article 16 provides that the contractor shall at all times maintain at its offices in Equatorial Guinea the original records and books of Petroleum Operations in accordance with all applicable regulations and the accounting procedure. They shall be supported by detailed documents demonstrating the expenses and receipts of the Contractor. Such records and books shall be used to determine the Contractor's gross revenues, petroleum operations costs and nets profits as well as to establish the Contractor's income tax and other payment obligations. These record and books should also include accounts showing sales of hydrocarbons.

The production sharing contract element derived from the hydrocarbon law provides that the Ministry, after notifying the Contractor, may have experts of its choice or its own agents examine and audit any records and book relating to petroleum operations. The Ministry has a period of three years from the date the Contractor submits to the Ministry records and books in accordance with Article 16.2, to perform such examinations or audit with respect to the said calendar year and submit its objections to the Contractor for any contradictions or errors found during such examination or audits.

The government has recently stepped up the audit of oil companies' financial statements and improved other aspect of managing oil-related transactions. Based on the audits that cover selected oil companies' activities during 1996-2001, the companies have recognized their obligation to pay an additional US\$88<sup>34</sup> millions, about 3 percent of GDP to the government.

The government operates under simple fiscal rules. The main rule follow by Equatorial Guinea authorities is that current expenditures are to be funded only from non-oil revenues. However this rule has not been effectively observed in recent years, and current expenditure in the 2005 budget exceeds non-oil revenue by more than 40 percent, and was covered through oil proceeds. This practice follows the Norwegian Petroleum Fund model, where a variable proportion of each year's net oil-tax revenue is transferred from the government's Petroleum Fund to the fiscal budget, essentially to cover the non-oil budget deficit.

Equatorial Guinea authorities have created a Fund for Future Generations (FFG) and committed to allocate 0.5 percent of oil revenues into the dedicated fund held at the BEAC. Furthermore the FFG it is clearly stated in the financing component of the budget document and has been adhered to in the recent years.

Equatorial Guinea revenues are collected by the Treasury in its BEAC and commercial bank accounts, through five commercial bank accounts, of which two are

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<sup>34</sup> IMF Country Report No. 03/385, December 2003 – Republic of Equatorial Guinea, 2003 Article IV Consultation, Staff report.

dollar accounts for receipt of oil revenues. Non-tax payments from oil companies are made directly into a Treasury account at the BEAC by the oil companies or GEPetrol acting as an agent of the government, and inform the MMIE. Tax revenues both oil and non-oil are collected through Treasury accounts in the commercial banks which are reconciled every day by Treasury.

Although these processes have been clearly defined in principle, there are several practical reconciliation problems between the BEAC, Treasury, and executing agencies in respect particularly to tax and non tax oil revenues. As oil companies only inform the executing agencies (Tax Directorate and MMIE) about their payments, both the BEAC and the Treasury have difficulties identifying the nature of the payment and how they should therefore account for. This lack of effective coordination between the executing and collecting agencies also means that executing agencies can face difficulties in assessing compliance with Production Sharing Contracts (PSC) and tax obligation by oil companies. To address this problem, the government has recently set-up a working group of Treasury, Tax Directorate, and MMIE officials to put in place and implement better coordination procedures.

Equatorial Guinea has been steadily putting in place the basis for a transparent management of its oil wealth however, more remains to be done. General principles are in place; nonetheless, the exhaustively of oil revenues accruing to the government remains unknown as the information is not publicly available. Adherence to the *Extractive Industries Transparency Initiative (EITI)* as agreed at the EITI London Conference in March 2005 would be an important milestone. Successful implementation of the EITI requires countries to meet, or exceed the agreed criteria which rest on six guiding principles:

- Publication of payments and receipts in a publicly and readily accessible form;
- Independent audit of payments and receipts by reputable audit firm applying international auditing standards;
- Payments and revenues are reconciled by a credible, independent administrator, with publication of the administrator opinion regarding that reconciliation;
- Extension of the above to all companies including national resources companies;
- Active engagement of civil society in the design, monitoring, and public debate around the implementation process, and finally;
- Commitment to a work plan and timeline for implementation.

The timely and newly EITI++ initiative recently launched by the Bank on April 12, 2008 to help developing countries, particularly African Countries, manage and transform their natural resource wealth into long-term economic growth that spreads the benefits more fairly among their people is the perfect framework for Equatorial Guinea.

The EITI++ further to improving transparency and accountability will rightly focus on the resource chain including managing revenues, and promoting sustainable and efficient utilization of resource wealth. It will provide governments with a slate of options including technical assistance and capacity building for improving the management of resource-related wealth for the benefit of the poor and notably the implementation of good policies.

Ensuring that the large Equatorial Guinea's oil endowment relatively to the size of the population is being translated into economic opportunities and benefices for the overall economy requires the assessment of the Budget formulation and execution; given that Equatorial Guinea oil-revenue are integrated into the budget<sup>35</sup> and particularly into the capital budget and partly in the current budget<sup>36</sup> therefore, the quality of budget execution matters for poverty reduction. However, the quality of budget execution depends on the quality of budget preparation or formulation.

## **B - Assessment of the Budget Formulation Framework**

The budget is the main vehicle and active instrument in hands of the government to support its development strategy and poverty reduction through efficient allocation of resources to put in motion the medium-term development vision. The immediate challenge facing the Equato-Guinean authorities is to prepare a comprehensive development strategy to reduce poverty and foster broad-based economic growth. A well formulated and prioritized budget is critical in this regard. With the substantial oil wealth, Equatorial Guinea should be able to make rapid progress toward achieving the MDGs.

The lack of a clearly stated medium-term development and poverty reduction strategy affects both resource allocation and performance. The budget document includes only very general statements about poverty reduction and infrastructural development objectives, and does not relate them explicitly to resource allocation in the budget proposal. Until 2001, the basic medium-term policy statement was the Medium-Term Economic Strategy 1997-2001 document. Currently, neither the current budget nor the investment budget or its associated Public Investment Program (PIP) can be assessed in term of specific policy priorities or objectives (IMF 2006).

Based on the Public Finance Law, the Budget Directorate in the Ministry of Finance and Budget (MFB) has overall responsibility for the preparation of the budget. The investment budget however, is based on the PIP prepared by the Ministry of Planning and Development (MPD), broadly in parallel with the current budget, but without any explicit links between investment and consequent recurrent cost. The

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<sup>35</sup> That justifies why there is a profound need for a sound Public Finance Management (PFM), if windfalls are to be translated into growth and durable poverty reduction; and because in principle, the budget is the very policy instrument through which the government expresses its priorities and policy actions.

<sup>36</sup> The absorptive capacity should then be carefully assessed and adequately dealt with furthermore, excess proceeds from windfalls should be invested in financial assets.

Ministry of Mines, Industry and Energy (MMIE) along with GEPetrol play a key role in the programming and forecasting of oil revenues.

Budget preparation for recurrent expenditure starts in late March when the Budget Directorate sends ministries procedural instruction for the drafting of their budget proposal for the coming fiscal year under 45 days dateline for submission. In this process, the Budget Directorate acknowledges expenditure allocation in the previous budget as a baseline, and ministries only need to justify proposed expenditure increases. In June, ministries meet in individual negotiations with the MFB to discuss their proposal only on deviations from the baseline. All proposals are then consolidated by the Budget Directorate and sent to the council of Ministers in August, where remaining disagreement are discussed and Ministers can raise new expenditure claims and disagreements are settled by the Prime Minister, or ultimately by the President.

Preparation of the investment budget follows a parallel path with no significant overall involvement of the MFB. A three-year rolling PIP is prepared without an explicit ceiling from the MFB for the coming fiscal year. Line ministries prepare and present their investment project to the MPD, where they are evaluated and, eventually, included in the PIP. Once the MPD has aggregated all approved investment projects, it sends the PIP to the Budget Directorate, where the first year is included as the investment budget and sent to the Council of Ministers for discussion, without questioning the overall level of investment, the priorities it expresses, or its medium-term financial implication. If it has not been received on time, the Budget Directorate sends its own estimation to the council of Ministers. At this stage, Ministers can still make new claim on resources on which the President holds the final decision. Once approved by the Council of Ministers and the President, the investment budget is incorporated into the budget bill by the budget Directorate as a single global appropriation.

The Budget Directorate has no significant role in revenue forecasts. Oil revenue forecasts are prepared by the MMIE, non-oil tax revenue forecasts are prepared by the Tax and Customs Directorates, and other minor revenue flows, such as administrative fees charged by ministries and government departments for state services, are projected by concerned institutions as part of the process of preparing the recurrent expenditure compartment of the budget. The Budget Directorate collects all these forecasts and incorporates them into the proposal that is submitted to the Council of Ministers and the President for approval.

Once the Council of Ministers and the President ratify each compartment of the budget, the Budget Directorate sends the draft law to parliament before the end of August for discussion in the September session, If the budget law is not enacted by parliament before the beginning of the budget year, the government operates on the basis of the previous year's budget until parliament convenes again in March, when an Amendment Budget Law is proposed to parliament.

Fiscal administration is dominated by the executive branch of government, with inherent dangers of over-centralization and inadequate checks and balances.

Parliamentary oversight of the budget needs to be progressively strengthened. Although the public finance law establishes the right of parliament to any information required to exercise this function, and requires the MFB to send a quarterly budget execution report to parliament; however, after discussing the annual budget law, the parliament is dissolved for six months and therefore plays a limited role either in authorizing changes to budget implementation or in scrutiny of the final account. It is noteworthy to mention that Parliamentary review of budget execution is consolidated with the passing of budget law in the September session; the budget execution report being a pre-requisite for passage of the following year's budget law. While this process ensures timely reporting of budget execution, it does not allow sufficient time for parliamentary scrutiny and an effective independent audit process; this leads us to the budget execution assessment.

## **C - Budget Execution and Monitoring Assessment**

The annual budget law comes into effect on January 1, following the approval by parliament and the President in October, for the calendar year ahead. The Public Finance Law defines various responsibilities in the budget execution process for spending agencies and ministries, the MFB, the different directorates of this ministry, and the Head of State or his delegate as *Ordenador*. The law also provides for a significant number of exceptions to the general norms.

The normal spending process<sup>37</sup> starts with ministries and agencies making claims for resources to the MFB, where the Directorate of Financial Control verifies the existence of appropriations for the expense in the budget. If appropriations are available, the MFB sends the payment claim for approval to the *Ordenador Principal* (President) if it exceeds 1 million CFA or to the *Ordenador Secundario* (Prime Minister) if it does not reach this threshold. If the expense is approved at this stage, the payment order is sent to the Treasury, where the funds are released by check directly to the payee designated by the ministry or agency responsible for the expenditure and the expenditure is recorded on cash basis by the Treasury and informed the Budget Directorate. It goes without saying that the budget execution or more precisely the expenditure process needs to be strengthened and better codified, and more so regarding control at the commitments level.

In the context of the lack of control at the level of commitments, it is common for payment claims to be made for commitments incurred by ministries or agencies for which there is insufficient or no appropriation<sup>38</sup>. In such cases, if the activity is deemed of high priority or it has already been contracted for, it is common for spending to be authorized on the basis of supplementary legislative or administrative procedures. According to the Public Finance Law, legislative approval should be obtained in such cases before the funds are drawn. Given that the parliament convenes only twice a year, the common

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<sup>37</sup> Republic of Equatorial Guinea: Report on the Observance of Standards and Codes – Fiscal Transparency Module. The IMF Country Report No. 05/144 April 2005.

<sup>38</sup> There is a need to bring this practice to an end, because it leads to misuse and waste of public funds given the weak existing control system and does not respect the integrity of the budget.

practice is to wait only for administrative approval of the expense and obtain parliamentary approval on an ex-post basis.

The Public Finance Law and the annual budget law also provide for administrative flexibility in expenditure management. The Council of Ministers can transfer appropriation through a decree that is ratified ex-post by parliament. Although the law requires allocation to be made at the level of chapters and specific spending units, it also authorizes global appropriations for expenditures that arise from unforeseen circumstance or could not be specifically allocated during the budget preparation process, and authorizes the Minister of Finance to allocate these resources during the fiscal year. The size of these appropriations apparently as a contingency reserve, have no explicit legal limitation.

The execution of investment projects is the responsibility of the Ministry of Infrastructure (MOI) and the MPD is responsible for overall coordination and oversight of the PIP. None of these institutions, however, have procedures in place, nor capabilities for monitoring commitments as to facilitate effective oversight and control of investment projects. This has contributed to significant expenditure overruns in the investment budget in recent years, which constitutes a waste of resources.

Financial control largely functions on an ex-ante basis. The Directorate of Financial Control in the MFB preauthorizes payments on the basis of existing appropriations, but final payment authorizations lie with the Prime Minister or the Head of State, depending on the value of each payment. The ex-ante financial control system was introduced because of concerns with payments control and potential misuse of funds. The Directorate of Finance Control is also nominally responsible for ex-post auditing of the budget execution. However, once payments are released and made, no systemic mechanisms have been established for public managers to account for resources and for internal review of payments and implementation of procedures.

The system of centralized and lengthy pre-approval procedure combined with weak and uncoordinated ex-post auditing lengthens the process of control over final payment and reduces accountability of public managers on budget execution, as well as the accountability of the Directorate of Finance Control and the Treasury for payment control. It also complicates cash management forecasting and control, and generates costly delay in the process of Budget execution

The Treasury is responsible for fiscal accounting and reporting. It produces quarterly execution reports covering all revenues and expenditures of institutions included in the budget law and submit them to the budget Directorate. These reports follow the budget classification, which defines general categories that can be grouped to show the overall balance and non-oil balance. Apart from the information contained in the budget execution law and the budget document, there is no legal or statutory requirement for the obligation of fiscal data. And quarterly budget execution reports sent to the Council of Ministers are not made available to public.

There is no formal mid-year review of the budget, though parliament receives preliminary information on budget in the first half of the year. The Standing Committee of parliament receives an execution report in or around July, together with any rectifications proposed by the government for the current budget; covering revenue and expenditure during the first half of the year. Quarterly execution reports are discussed by the Council of Ministers but not made public nor sent to parliament. Hence, the parliamentary oversight role needs to be strengthened.

The existing budget execution framework needs to be substantially strengthened and subsequently, expenditure process needs to be streamlined and the annual expenses fully integrated into the budget law adopted by the parliament without any exception<sup>39</sup> for the government to authorize spending which have not been included in the Finance Law. There is also a pressing need to undertake the preparation of a MTEF integrating the PIP into the normal budget execution framework and process and to enhance its implementation and monitoring. Furthermore, there is a need to improve accountability and strengthen the oversight structure for more transparency in the process of budget execution.

## **VI. Conclusion**

In principle, the Dutch Disease is a matter of one sector benefiting partly at the expense of others, therefore not an impediment *per se*; however the disease is potentially harmful if there is something special about the reallocation of resources between sectors; for example from high-tech service industries with important spillover effects to low primary production. The oil boom would therefore induce a decline in a technologically leading sector of the economy with adverse consequence for long-term growth: The resource shift can then become a true disease.

The magnitude of negative macroeconomic consequences of the Dutch Disease will depend however on the country's economic structure and the stage of development, hence will vary from country to country. A country where a manufacturing sector does barely exist or where the non-oil primary sector is structurally deficient as it has been the case of Equatorial Guinea; there is little to fear about the disease. In that context the oil boom become a blessing rather than a curse, given that oil revenues when properly managed, can play a special and critical role in overall economic development and poverty reduction in low-income countries like Equatorial Guinea. Although the GDP per capita has substantially increased from US\$ 346 in 1995 to US\$ 3391 in 2004 due to the coming on stream of important oil fields, nonetheless, EQG remains among the poorest countries by standard of living conditions and the level of development.

It is noteworthy to emphasize that Equatorial Guinea is a tiny country of 28,000 km<sup>2</sup> with a relatively small population estimated at about 506,000 inhabitants, therefore the traditional export sector cannot be expanded and the country does not have any

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<sup>39</sup> The rule should be to fully integrate annual government expenditure into the budget and safeguard the budget's integrity, to avoid misuse of public funds in the context of weak internal control and weak accountability.

specific comparative advantage in the traditional export sector. Continual mobilization of resources in the sector is costly because of the poor marginal return the sector can yield and at the same time it deprives the economy of critical resources needed to develop other strategic sectors; therefore it constitutes a waste of resources. The traditional export sector will certainly disappear due to the necessary ongoing reallocation of resources within the economy. The sector could then be substituted by the emergence of a competitive food production sector to warrant food security and limit the dependency on imported foods.

It is critically important for Equatorial Guinea authorities to reorient their resources and development efforts where the country could have proven comparative advantage; for example tourism and to develop other export niches and sectors of the economy which can generate as much as foreign exchange earnings than the traditional export sector. Food constitutes by far the largest single item of household consumption in general. Oil proceeds can be invested in raising the productivity of farmers by financing improved seed variety for local production to support the transition from the traditional agricultural export sector to increase local food production. The tertiary sector globally needs government attention toward a service-based economy supported by oil-revenues during the transitional period. This backdrop does not mean that the manufacturing sector should not exist on the contrary, the new-economy in the making will demand a different type of industries and manufacturing alongside the service based and oil dominated economy.

In addition, Equatorial Guinea is currently the only Sub-Sahara African oil-producing country where oil revenue clearly exceeds the country's absorptive capacity and where sizable foreign assets have been accumulated. The widespread poverty and low human indicators in Equatorial Guinea also argue for upgrading domestic infrastructure and increasing public services so as to improve the quality and productivity of physical and human capital. Investment in financial assets would build the reserves needed to gradually increase capital investment as absorptive capacity improves. The current fiscal rule, that the government is trying to follow, is to use non-oil revenue to finance current expenditures and oil revenue to finance capital expenditure, and to save what is left: this rule is prudent, and predictable although not rigorously applied.

Equatorial Guinea authorities have steadily put in place the basis for a transparent management of its oil wealth however, more remains to be done. General principles are in place; nonetheless, the exhaustively of oil revenues accruing to the government remains unknown as the information is not publicly available. Adherence to the *Extractive Industries Transparency Initiative* (EITI) as agreed at the EITI London Conference in March 2005 would be an important milestone toward greater transparency and efficiency in oil management for poverty reduction. In the same time, authorities need to tighten budget execution procedures and internal financial controls to safeguard the budget integrity and public resources, and for greater accountability.

Foremost, the timely and newly EITI++ initiative recently launched by the Bank on April 12, 2008; to help developing countries, particularly African Countries, manage

and transform their natural resource wealth into long-term economic growth that spreads the benefits more fairly among their people is the perfect framework for Equatorial Guinea. The EITI++ further to improving transparency and accountability will rightly focus on the resource chain including managing revenues, and promoting sustainable and efficient utilization of resource wealth. It will provide governments with a slate of options including technical assistance and capacity building for improving the management of resource-related wealth for the benefit of the poor and notably the implementation of good policies.

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