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Leave the Volatility Fund Alone: Principles for Managing Oil Wealth

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Abstract

How should capital-scarce countries manage their volatile oil revenues? Existing literature is conflicted: recommending both to invest them at home, and save them in sovereign wealth funds abroad. I reconcile these views by combining a stochastic model of precautionary savings with a deterministic model of a capital-scarce resource exporter. I show that both developed and developing countries should build an offshore Volatility Fund, but refrain from depleting it when oil prices fall because it cannot be known when, or if, they will rise again. Instead, consumption should adjust and only the interest on the fund should be consumed. To do this I develop a parsimonious framework that nests a variety of existing results as special cases, which I present in four principles: for capital-abundant countries, i) smooth consumption using a Future Generations Fund, and ii) build a Volatility Fund quickly, then leave it alone; and for capital-scarce countries, iii) consume, invest and deleverage, and iv) invest part of the Volatility Fund domestically, then leave it alone.

Keywords: Natural resources, oil, volatility, sovereign wealth fund, precautionary saving, capital scarcity, anticipation.

JEL Classification: D81, E21, F43, H63, O13, Q32, Q33

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