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Challenges of Transforming Commodity-based Economies in a Fast-Changing World

Introduction

Botswana, Chile, Norway. What connects these countries? Not geography. Not history. Not language. Apart from being fantastic places for a holiday, these three countries have also overcome the dreaded 'resource curse'. While we can add Canada to the list – yet another nice place to visit – there are vanishingly few countries around the world that have successfully managed the distortions and economic challenges presented by resource wealth. And the list of those that have failed - sometimes spectacularly - is far longer.

I'll start with a confession - I'm a bit nervous. Like all of you, I have given talks like this on a variety of topics. What I've not done is stand in front such an august gathering of scholars and practitioners, many of whom know far more about my subject than I ever will. With this in frame, what I hope to achieve this evening is not to teach you - that would be impossible - but to instigate a conversation on the implications of an increasingly uncertain world for commodity-based economies (which I will refer to as CBEs).

Why does this interest me? Earlier this year, I left my position at the Asian Development Bank [my nerves are slightly heightened by the fact that my previous boss sits amongst you in the audience] for a new role as Governor of the National Development Fund (NDF) in Saudi Arabia. Despite having been raised in the snowy Green Mountains of Vermont, I have somehow developed a professional affinity for the warmer climates of Southeast Asia and now the Gulf.

NDF is a start-up and we are tasked with supporting the diversification of the Saudi economy as well as its transition from government- to private sector-led. NDF's leverage comes from our oversight of five large domestically focused sector development funds and the Saudi Fund for Development.

With a per capita GDP of nearly $56,000, the Kingdom ranks amongst the world's wealthiest countries. The country also ranks amongst the most resource dependent with oil accounting for more than 40% of GDP, 70% of fiscal revenues and close to 80% of exports.[1] The IMF and World Bank, as well as many think tanks and

[1] https://www.imf.org/~/media/Files/Publications/CR/2019/1SAUEA2019002.ashx IMF Selected Issues Paper

universities and indeed the government itself, have all done great work on the importance of economic diversification in Saudi Arabia.

And this concept of diversification is not that new. Ahmed Yamani, the Kingdom's Oil Minister in the '60s, '70s and '80s was known for often repeating the phrase: "The stone age did not end for lack of stone, and the oil age will end long before the world runs out of oil". The difference now is the country has a long-term strategy – Vision 2030 – for diversification and instruments, in the form of NDF, the Public Investment Fund and others, for realizing this goal.

Let's think about the Kingdom's road ahead as we might a long ocean journey. We have an objective – breaking the resource curse; a navigational chart in Vision 2030; and a vessel in the form NDF. Shouldn't we be able to learn from those that have preceded us? Other countries that have embarked on this journey? To abuse the metaphor even more, this trip sadly has far many more shipwrecks than successful navigations. But this is not to say that there aren't important lessons we can learn.

Shared features and risks of commodity dependence

I'll start by outlining a few features common to many CBEs and the risks they face. These are not necessarily specific to Saudi Arabia but are seen across many resource rich economies. First, a CBE is defined as one with more than 60% of its exports composed of commodities.[2] Using this definition, UNCTAD classifies 102 out of 189 countries (or 54%) as commodity-dependent. An important feature is that this is largely a developing country challenge with 90% of low-income countries facing commodity dependence, versus 50% and 30% for middle- and upper-income countries, respectively.[3]

Such heavy dependence on commodity exports creates several challenges. Most scholars focus on five interrelated factors: (1) slow economic growth; (2) vulnerability to economic shocks; (3) weak governance, institutions, and accountability; (4) low human development and inequality; and (5) social instability, civil unrest and conflict.

Let me take each of these in turn. Slow economic growth in these countries is often a function of "Dutch disease" whereby large foreign currency resource revenues artificially inflates the local currency which negatively impacts competitiveness in the non-resource sectors of the economy.

CBEs are also susceptible to exogenous economic shocks given the inherent volatility of commodity prices which, in turn, impacts government revenues. Pro-cyclical government spending in the good times and the underdevelopment of non-resource sectors (the result of Dutch disease), leaves these economies particularly vulnerable with few alternatives when facing swings in commodity prices.

On governance, institutions and accountability, as I noted previously, the vast majority of CBEs also fall in the least-developed category where institutional development lags. The absence of strong institutions combined with a concentration of revenue sources, often results in poor accountability, governance and corruption.

Low levels of human development and inequality are very much related to poor governance, weak institutions and a lack of accountability. But these are also a function of instability in government budgets which can rise and fall dramatically with commodity shocks. Social programs and safety nets often fall victim to austerity

[2] https://unctad.org/en/PublicationsLibrary/ditccom2019d1_en.pdf
[3] ibid

budgets necessitated by a fall in commodity-based revenue – a fact that influences poverty incidence and human development.

And finally, a combination of these factors, together with fights over the control of resource rents, often leads to social instability, civil unrest and conflict.

Arguably, there is considerable endogeneity in these variables and different countries face each of these challenges to differing degrees, with least-developed countries most at risk. One thing we can say for certain is that what we see happening today in countries like South Sudan and Venezuela are live examples of interaction across all these factors. And they serve as a powerful lesson on the risks of revenue concentration.

Models for mitigating risks

All of these challenges aside, a number of countries – most notably Botswana, Canada, Chile and Norway – have managed to overcome the challenges associated with resource-dependence. These countries are on four different continents and, as I mentioned previously, have little in common, aside from the fact that Canada and Norway are in the northern hemisphere and produce oil and gas and Botswana and Chile are in the southern hemisphere and produce minerals (diamonds for Botswana and copper for Chile). And, perhaps not surprisingly, each of these four countries chose a slightly different path to breaking the resource curse.

For the purposes of this discussion, let me identify key features of each country's approach. I should note in advance that this is far from an exhaustive list.

Canada's path is largely one of central regulation and devolved oversight. The federal National Energy Board – recently renamed Canada Energy Regulator – reports to Parliament as an independent economic regulatory agency. While responsibility for taxes, royalties, incentives, permits and licensing is given to sub-national bodies.

In Chile, the focus has been on enhancing transparency. The Ministry of Finance publishes information on revenues and operations in the mining industry as well as comprehensive analysis of taxes, royalties, mining export values and production volumes. The Mining Ministry and the Chilean Commission on Copper also publish information, including environmental assessments and licensing petitions.

Norway's focus has been on revenue segregation. One hundred percent of oil earnings are set aside into the "Government Pension Fund Global" with up to 3% withdrawn annually for public services. The purpose of the "Oil Fund" is to prevent currency appreciation, wealth concentration and revenue mismanagement.

And Botswana has a three-pronged approach – pursuit of economic diversification; sustainable fiscal policy and counter-cyclical spending; and investment of resource wealth through the "Pula Fund" which acts as a stabilization fund and a savings vehicle for future generations.

While this oversimplifies what are complex policies and reform processes, it does highlight that there is no single path to reducing the negative impacts of commodity dependence. Interestingly, of the four, only Norway is a member of the Extractive Industries Transparency Initiative.

Even so, these four countries do share a commitment to governance, strong institutions, human development and transparency. It is also important to note that their commitment is long-term in nature, requiring sustained and focused national efforts over an extended period of time.

Economic uncertainty, monetary policy and commodity dependence

Now, with a common understanding of the challenges faced by CBEs and an appreciation for how some have successfully mitigated associated risks, what does today's turbulent world mean for resource dependent countries?

An obvious challenge for all CBEs is the volatility of commodity prices. Indeed, this is an issue of global concern and has been a focus of discussion for the G20 since the Finance Ministers and Central Bank Governors commitment in 2009 to "work to address excessive commodity price volatility". This focus has continued through the G20 finance stream and the Commodity Markets Working Group.

Before the global financial crisis, the simplified model of monetary policy and commodity prices was one where low interest rates meant higher commodity prices. Since the crisis this relationship has become more complex. This was most notable in 2014 when increasingly hawkish signals on the shift from accommodative monetary policy from the US Fed resulted in dollar appreciation which lead to a plunge in commodities, even as interest rates remained at historically low levels.

The collapse of the decades-long commodity 'super cycle' had other causes too. Not least of these were structural changes like cooling off of growth in demand in China and other Asian economies, the emergence of shale oil in the U.S. and Canada, and technological change, among others. What is clear though is that the once reliable connection between interest rates and commodity prices is no longer so dependable.

While it is likely that this historic inverse relationship will hold over time, the interaction between the strength of the US dollar as a reserve currency, monetary policy and commodity prices will not be as predictable as it has previously been. Consequent ambiguity and volatility are only heightened by growing trade tensions, geopolitical uncertainty and erratic climate patterns.

And all this volatility comes at a cost. Government budgets become harder to forecast and the well-documented procyclical tendencies of many CBEs mean that inevitable cycles have a negative impact on medium-term fiscal planning and public financial management which, in turn, can translate into downward pressure on economic growth, skewed income distribution, and increased poverty incidence.

What are CBEs to do? In addition to the strategies employed by Botswana, Canada, Chile and Norway, an important element is to develop fiscal frameworks that take into account large uncertainties. The IMF suggests that because commodity resources are non-renewable, long-term strategies can help avoid unsustainable policies and ensure greater intergenerational equity. And, naturally, these policies must take into account the high degree of uncertainty surrounding commodity revenues.[4] A non-trivial element here is to limit the "optimism bias" that often influences official government forecasts.

Back to the question I started with: what does today's uncertain world mean for resource dependent countries? There is no surprise answer here – the same historic array of challenges confronts CBEs. But these

[4] https://www.imf.org/external/pubs/ft/howtonotes/2016/howtonote1601.pdf

countries now need to anticipate an even higher degree of uncertainty and the likelihood of more market volatility.

This simply highlights the critical importance of fast-tracking the reforms and structural changes necessary to promote economic diversification and insulate their economies from exogenous shocks. And, as noted previously, I cannot underscore enough that this requires sustained and focused national efforts over an extended period.

What does this mean for Saudi Arabia?

So, what does all of this mean for Saudi Arabia? While my seven months in the country make me little more than an interested observer, I would posit that the country has drawn important lessons and is addressing the challenge of commodity dependence on three fronts: economic diversification, transparency and price stabilization.

Economic diversification

Economic diversification is central to Vision 2030 – the Kingdom's development plan – with two of its three pillars focused on reforms necessary for this transformation. The "Vision" is an ambitious plan to reduce Saudi Arabia's dependence on oil, diversify its economy, and create a "high-performing government that is effective, transparent and accountable".

This articulation is precisely the kind of focused national commitment that is central to successfully avoiding the pitfalls of resource dependence.

Transparency

Transparency is also a feature common to CBEs that have broken the resource curse. And the planned IPO of Saudi Aramco brings an unprecedented level of transparency to the Saudi oil sector. Last April, in anticipation of its first international bond sale, key financial and operations indicators were revealed for the first time, an important milestone for this state-owned giant.

And the stated objective of transferring proceeds from the IPO to the Public Investment Fund – the country's sovereign wealth fund – is a form of revenue segregation not unlike that of other successful CBEs.

Price stabilization

And finally, the Kingdom has a somewhat unique role in another area: commodity price stabilization.

As the world's second largest producer and a central player in OPEC, Saudi Arabia has a critical role in oil price stabilization. A recent study[5] by researchers at the King Abdullah Petroleum Studies and Research Center (KAPSARC) found that OPEC's spare capacity reduces oil price volatility and generates between $170 and $200 billion in annual economic benefits for the global economy. Spare capacity held by the Kingdom as OPEC's dominant swing producer is deployed in response to disruptions, thus saving costs that would otherwise result from price volatility.

[5] https://www.iaee.org/en/publications/init2.aspx?id=0

Such price stabilization benefits the country in reducing volatility and allowing for better medium-term fiscal planning but it is also of great benefit to the rest of the region and the world.

Role of the National Development Fund

As I mentioned at the beginning of these remarks, my organization – the National Development Fund – is tasked with supporting the diversification of the Saudi economy as well as its transition from government- to private sector-led. At the outset, our objective is to increase the effectiveness, efficiency and sustainability of development financing across the country.

We are also in the process of developing a long-term strategy and see a number of additional ways in which NDF could support transformation in the Kingdom, including: stimulating domestic long-term investment; promoting job creation; encouraging entrepreneurship; deepening SME development; supporting export promotion; providing essential public services to vulnerable segments of society; and mitigating risk for investors.

In principle, NDF could also act counter-cyclically during economic down cycles, thus reducing pressure on the national budget. All of this would help enhance productivity in both the public and private sectors – a critical factor in addressing risks associated with resource dependence. This would position NDF to play an important role in facilitating the country's economic and social transformation.

Conclusion

As we learned from the experience of Botswana, Canada, Chile and Norway, there is no single path to breaking the resource curse. It is also clear that the future is likely to bring more uncertainty and thus exposing CBEs to even greater risks. The saying that one should "make hay while the sun shines" must be heeded by CBEs. Today's low interest rates and relatively stable commodity prices are the time to undertake the kinds of reform necessary to mitigate the risk of commodity dependence.

In conclusion, I am happy to say that Saudi Arabia is heeding this advice. The challenge going forward is sustaining current high-level government commitment to reform – a key ingredient for realizing the ambitious transformation articulated in Vision 2030. Continued engagement from the outside is also invaluable as the country pilots the choppy waters of economic transformation. And the Kingdom's G20 presidency is an excellent opportunity for the rest of the world to provide perspective and support as Saudi Arabia navigates this journey.

Thank you.

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