Can a country avoid natural resource curses?

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Abstract:

The aim of this brief is to share the knowledge I acquired during my two weeks in Mauritius, where I attended a course on "**Macroeconomic Management in Resource-rich Countries**" that was jointly offered by the Capacity Development Institute of the International Monetary Fund (IMF) and Africa Training Institute. The lesson I have learned is that it is possible for a country to turn its resources wealth into blessings by implementing the right mix of policies, good governance, and strong institutions. Therefore, I recommend the following policies:

The government should establish a South Sudan Sovereign Wealth Fund (SWF) which will include components like Stabilization Fund to mitigate the economic shock caused by the unfavorable price of natural resources, as well as reserves, development, and future generation funds, as a first line of defense during a crisis.

The coordination of fiscal, monetary, and exchange rate policies is crucial for macroeconomic stability. A gradual fiscal response to the crisis can mitigate inflation and real exchange rate impacts, enabling central bank to maintain price stability. Government should use non-resource balance and price-based fiscal rules as fiscal anchors.

Economic diversification, initiated before commodity revenues declined will encourage investments in high-productive industrial clusters, provide export subsidies, and public-private partnerships to establish new firms and upgrade skills, while holding firms accountable for their export performance.

Keywords: Macroeconomic Management, Sovereign Wealth Fund, Fiscal, Monetary, and exchange rate policies, Economic Diversification, Dutch-disease.

1.0 Introduction

South Sudan, despite its abundant natural resources like petroleum, gold, iron ore, marble, and aluminum, have been largely remain unexploited due to ongoing civil war and inadequate infrastructure. Prior to independence, South Sudan produced 85% of Sudanese oil, accounting for 98% of government revenue[1]. However, the country's civil war and violence have significantly impacted oil production, leading to the diagnosis of a resource curse, or Dutch disease.

Resource-rich countries (RRC) often experience slower growth due to the "resource curse" or paradox of plenty[2]. This concept, first introduced in the 1950s-60s, suggests that countries with abundant natural resources, such as oil and copper, tend to grow slower than those without resources. Studies have shown a strong correlation between resource abundance and poor economic growth. However, countries like Botswana and Norway have managed to avoid this curse by transforming their resources into blessings for their populations[3].

Common features in Resource-Rich Countries include:

- Low & Volatile Growth
- Procyclical Macro Policies
- Low Savings
- Inefficient Public Investment
- Dutch Disease
- Internal and External Conflicts

Consistency between fiscal and monetary policies is crucial in resource-rich countries, but it becomes challenging during difficult times. Economic challenges for policymakers include short-run shielding of budget from commodity revenue volatility, long-run leverage of resource wealth for economic development, long-term savings for fiscal sustainability, and the choice between saving financial assets or other assets like infrastructure and education. An appropriate macro policy framework is essential for addressing these challenges.
Three policy measures that must be adopted by rich resource countries include:

1. **Structural economic policies:** Low levels of diversification in Resource-Rich Countries (RRC) raise concerns about short-run macroeconomic stability and long-run growth sustainability. Economic diversification can reduce volatility and disperse risks. Soft industrial policy involves government coordination, infrastructure development, human resources development, export promotion, and certification standards. Hard industrial policy involves tax incentives, targeted subsidies, state guarantees, direct lending to sectors like agriculture, and direct investment by state-owned enterprises. Both policies aim to reduce macroeconomic volatility and promote sustainable economic growth.

[1] What Are The Major Natural Resources Of South Sudan? - WorldAtlas
[2] Natural resource curse: A literature survey and comparative assessment of regional groupings of oil-rich countries - ScienceDirect
[3] Did Botswana Escape from the Resource Curse?; Atsushi Iimi; IMF Working Paper 06/138; June 1, 2006

2. **Financial inclusion:** Financial inclusion refers to the access to and utilization of financial services like payment, savings, credit, insurance benefits, and household services, including agricultural insurance firms and start-ups and small and medium scale Enterprises (SMEs). Increased financial inclusion can enhance people's responsiveness to **interest rate changes**, enhancing the effectiveness of central bank rate (Monetary Policy Rate) as an indirect policy instrument.

3. **Fiscal policy:** Resource exhaustibility necessitates intertemporal decisions on resource consumption and saving, impacting intergenerational equity and long-term fiscal and external sustainability. Medium-term fiscal rules and precautionary savings are needed due to revenue volatility.

Approaches to expenditure decision:

a. **Hartwick's Rule** suggests that countries should invest all profits or rents from natural resources in reproducible capital like machines to maintain national wealth constantly and promote sustainability[4].

b. **Spend-as-you-go policy:** The spend-as-you-go approach is a government strategy where expenditure is raised as revenues increase and cut when revenues fall. This approach has been linked to procyclical fiscal policy and boom-and-bust cycles in expenditures. However, it is a bad approach of fiscal policy due to its volatility in growth and expenditure.

As a result, the following Approaches have been adopted to limit procyclicality: An expenditure growth rule can mitigate procyclicality by regulating government spending growth in nominal, real, or non-resource GDP terms:

a. **Permanent Income Hypothesis (PIH)[5]:** The government and households prefer smooth consumption due to budget constraints, which ensure stability and allow for savings and borrowing. The PIH Rule spreads consumption equally over time, focusing on interest earned in total wealth (financial assets and resources underground). However, limitations of the benchmark include some countries' inability to access credit markets and significant uncertainty in the net present value of resource revenues, particularly underground assets.

[4] World Bank Document

[5] The Permanent Income Hypothesis (PIH)

b. **Bird-in-Hand Rule[6]:** The BIH rule is a more conservative approach to budgeting, storing natural-resource revenues in Sovereign Wealth Funds. The government can only finance its budget using interest earnings on revenues saved in the fund, with a real-world example in Norway.

An effective fiscal framework to manage volatility and exhaustibility must include:

Fiscal target	Objective	Short run strategies	Long run strategy
Macro stability	Pursue fiscal stabilization & fiscal sustainability	• Avoid pro-cyclical fiscal policy • Pursuing counter-cyclical fiscal policy • Higher and more stable non-resource revenues	• Ensure fiscal sustainability (e.g., through PIH and BIH) • Reduce fiscal deficit
More stable revenues	improve taxation of resource & non-resource sectors		
Better use of resources	Spend efficiently & equitably		
Strong fiscal institutions	Improve medium-term planning & investment institutions		

4.Monetary Policy Frameworks in RRC

The RRC's exchange rate regime should be determined based on the country's context, but it can be used to cushion the economy from shocks through fiscal rules or the exchange rate regime. The ER regime is a key tool in macroeconomic policy, complemented by other fiscal policy tools.

Fixed exchange rate regime	Flexible exchange rate regime
• Monetary Discipline and Inflation	• Provide "cushion" for shocks.
• Anchors expectations.	• Correct imbalances.
• Reduces ER risk.	• Lower vulnerability to crises.
• Stimulate trade, investment, FX borrowing.	• Allow monetary independence and free capital movement.

NB: Exchange rate stability can be achieved through strong growth, low inflation, a sustainable current account deficit, and a sustainable debt level, and the government should build sufficient foreign exchange reserves for central bank intervention in the market.

[6] The Bird-in-Hand Principle: Who I am, What I Know, and Whom I Know | Harvard Business Publishing Education

D. Sovereign Wealth Fund as a tool for Managing Natural resources funds

Oil price swings can complicate macroeconomic management due to their large, long-lasting, and asymmetric nature. This leads to a need for resource conservation for precautionary purposes. Policymakers are encouraged to build liquidity buffers to smooth consumption spending when resources inflow is short. Natural resource funds help address resource revenue volatility, meet development needs, and save for future generations. These funds should be seen as complementary policy tools, derived from actual fiscal surpluses and the government's cash management strategy.

Therefore, a Sovereign Wealth Fund can be divided into four groups:

1. **Future Generation Fund:** The Future Generation Fund aims to transfer wealth over generations, with funds withdrawn when petroleum resources are depleted and invested in foreign assets.
2. **Development Funds:** Investment in developing countries' domestic economy yields high returns, making it advisable to allocate funds towards socioeconomic projects like road, education, and health.
3. **Stabilization Fund:** The stabilization fund aims to protect the budget and economy from fluctuating commodity prices.
4. **Reserve Funds:** A managed floating exchange rate requires an accumulation of reserves from the resource windfall. Therefore, the Central Bank should outrightly purchase oil proceeds using the local currency reserves to build its foreign reserves

E. Recommendations:

1. **Establish a South Sudan Sovereign Wealth Fund:** The Stabilization Fund and other SWF components, such as reserves and future generation funds, act as shock-absorbers against unfavorable natural resource price changes. These funds could have mitigated the severity of the current economic shock by providing a first line of defense.

2. Fiscal, Monetary, and Exchange rate policy coordination: The importance of fiscal, monetary, and exchange rate in macroeconomic stability should be recognized by policymakers. A gradual fiscal response can mitigate inflation and real exchange rate impacts, aiding Central Bank price stability. Governments should use non-resource balance and price-based fiscal rules as fiscal policy anchors.

3.Economic diversification: Diversification, a strategy that began before commodity revenues declined, involves investing in high-productivity industrial clusters, even without a prior comparative advantage. Export subsidies and public-private partnerships can help establish new firms and upgrade skills, while holding firms accountable for their export performance.