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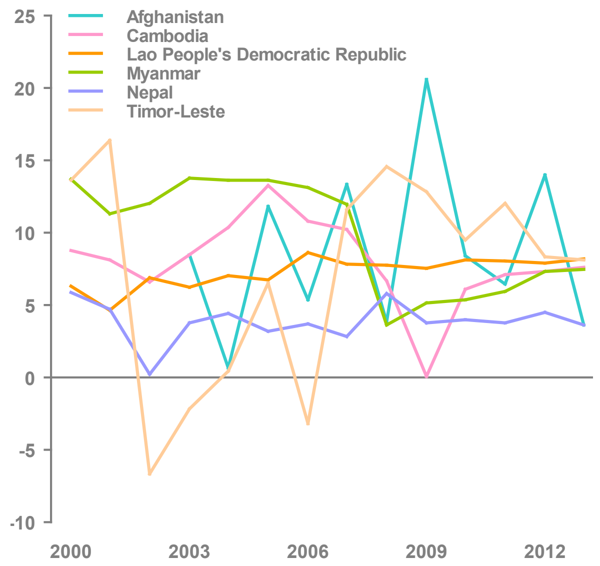
Macroeconomic policies in post-conflict resource rich countries

Introduction

Many resource-rich countries have failed to achieve sustained and stable growth, with economic diversification elusive and poverty reduction slower than in countries without such endowments (See figure 1 and table 1) Stable growth, diversification and poverty reduction become much harder to achieve when a resource rich country suffers from internal conflict.

Figure 1. GDP growth of conflict countries (percentage)



Sources: ESCAP, based on data from IMF, World Economic Outlook Database April 2014 and national sources.

The problem becomes even greater in resource rich countries because of the domestic instability generated by global commodity markets even in the absence of conflict. The purpose of this Policy Brief is to suggest guidelines for macroeconomic policy when the challenge of natural resource management confronts the need for post-conflict peace building.[1]

By necessity the public sector plays a major role in resource rich countries. This may take the form of direct public ownership of the resource and the processes of extraction and marketing. When the oil fields and mines are privately owned, the public sector cannot avoid monitoring and regulation of the industry including responsibility for environmental impacts. Failure to do so results in substantial revenue losses.

In conflict affected countries the role of the public sector is even more unavoidable. Almost all conflicts result in capital flight and collapse of private sector confidence. As a result, economic recovery in the post-conflict period will be led by the public sector, which can be described as *public sector-led growth in anticipation of private sector recovery*. When one puts natural resources and post-conflict together the public sector faces major challenges and new responsibilities. This is because the peace dividend needs to be visible quickly and at the same time equitable. This requires policies for sustained, inclusive and equitable high growth.

Table 1. Human Development Index (HDI) and Diversification Index

Country	HDI (Rank)[a] as of 2013	Diversification Index[b] (USA = 100)
Afghanistan	0.374 (175)	6.3
Cambodia	0.543 (138)	7.3
Lao People's Democratic Republic	0.543 (138)	4.1
Myanmar	0.498 (149)	5.9
Nepal	0.463 (157)	9.1
Timor-Leste	0.576 (134)	0.8

Sources: (a) United Nations Development Programme, Human Development Report 2013; (b) ESCAP based on trade date from the United Nations Commodity Trade Statistics Database (COMTRADE).
Notes: Diversification index is measured using trade data as a proxy for production data, where 100 corresponds to diversification in USA in 2010. Products are classified using six-digit HS 2002 classification further differentiated based on their unit value.

Macro policies for inclusive recovery and stable growth

Conventional macroeconomic policies, derived from a theoretical framework of efficient markets and quick adjustment to full utilization of resources, has little relevance for post conflict and resource based countries, and even less for the two combined. The lack of relevance results from several typical characteristics and outcomes when resource rich countries emerge from conflict.

First, conflict countries experience large capital flights. This becomes qualitatively worse during conflict and immediate post-conflict periods with large foreign exchange earnings from natural resources.

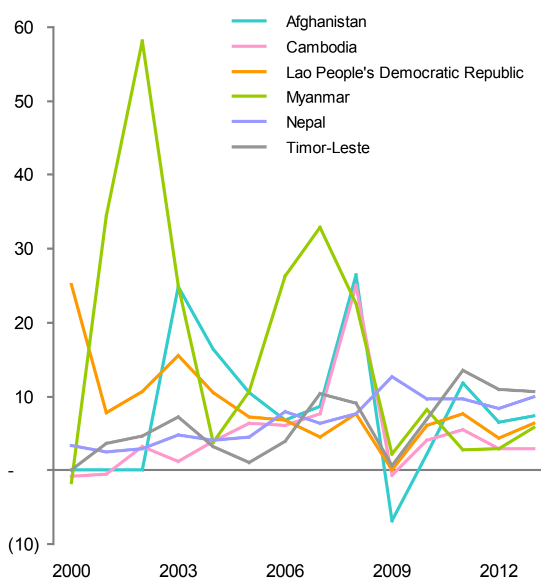
Second, bottlenecks that result from the destruction of infrastructure cause structural inflationary pressures in post-conflict countries. These pressures are magnified by the excess demand generated by public expenditure that results from natural resource revenues.

Third, during conflict countries typically suffer emigration of skilled workers, which undermines effective public administration and creates obstacles to private sector recovery. The loss of skilled people can result in deterioration of the ability of the public sector to implement post-conflict recovery. In the private sector, shortages of skilled staff can exacerbate capacity problems created by conflict.

As a result of these characteristics governments of conflict affected, resource rich countries face a combination of extreme underutilization of economic capacity and strong inflationary pressures (See figure 2). Attempt to suppress the latter before overcoming the capacity problems by applying the conventional approach adds austerity induced misery to the legacy of conflict. This can seriously jeopardize peace and reignite socio-political instability.

Nonetheless, the immediate task in a post-conflict country is macroeconomic stabilization. This stabilization need not focus on fiscal "consolidation" and suppression of inflation through demand-reducing policies. Instead, stabilization in post-conflict countries has to focus on two central elements: (a) managing the balance of payments in order to stabilize the exchange rate, and (b) use of fiscal policy to achieve aggregate production close to full potential. The export revenue generated by natural resource endowments as the country recovers facilitates these stabilization tasks.

Figure 2. Inflation in conflict countries (percentage)



Sources: ESCAP, based on data from IMF, World Economic Outlook Database April 2014 and national sources.

Exchange rate stability represents the key to inflation control in a post conflict country. This is frequently achieved through foreign assistance inflows. In resource rich countries the recovery of mineral or hydrocarbon production and the associated export revenue reduces the need for official assistance. Reliance on domestic resources rather than official inflows can increase government's policy flexibility.

This flexibility is crucial for making fiscal policy more development oriented. In trying to bring aggregate production close to full potential, both level and composition of government expenditure play a critical role. Public expenditure should be directed to sectors that directly boost both productivity and employment, such as employment-intensive physical infrastructure.[2] This will help prevent overheating. Public expenditure should also be directed to social sectors, in particular education and health, as peace dividends and instruments to make growth inclusive.

Monetary policy essentially plays a supportive role in order to ensure reasonable price stability together with exchange rate stability, maintain credit flows to the productive sector and to make the financial sector more inclusive.

Managing capital flows

The key policy step toward post-conflict recovery is reduction of capital flight in the short run, and in the medium term to reverse it through stable growth that increases private sector confidence in the economy.

Limiting capital flight requires implementation of several complementary measures as highlighted in several ESCAP documents:[3]

1) introduction of limits on capital account convertibility;
2) effective monitoring of private sector enterprises in the natural resource sectors;
3) creation of a "natural resource fund" to hold a portion of export earnings; and
4) close coordination among the central bank, ministry of finance and ministry responsible for mineral and hydrocarbon extraction.

The first of these measures allows a government to reduce capital outflow that prevents the stabilization of the aggregate economy. Once the short term measures become effective the government can convert them into market-based controls. Taxing capital movements based on how long funds are held in the country is a common form of these controls.

Capital controls of any type will not prove successful without effective monitoring of the enterprises engaged in the extraction and export of natural resources. The practice of transfer pricing is perhaps best known of the techniques to conceal outflow of funds. Considerably more important for resource based economies is false reporting of exports volumes. Mining exports enterprises must be closely monitored to ensure that they accurately report the ore content of partially processed materials. For hydrocarbons concealing capital flows takes the form of misreporting of the quality of the oil or gas. This monitoring requires considerable technical expertise. If the public sector lacks sufficient expertise in the post conflict period, it can seek external help, both from governments and international organizations, such as the UN.

An additional way companies avoid domestic taxation is the practice of negotiating their sales in a third country. By making the contracts in a third country it becomes difficult for both the governments of the host country and of the country in which the company is registered to have access to the financial details. This problem can be partially managed by requiring companies to negotiate all export contracts in the producing country.

Problem of over-heating

After the physical destruction and human suffering that conflict creates, governments come under great pressure to increase expenditures. If the public authorities achieve effective monitoring of resource extracting companies the revenue gain is likely to exceed the capacity of the conflict-affected economy to absorb. The combination of an inflation-prone post conflict economy and large resource revenues has the potential to generate unmanageable price increases. A natural resource fund could avoid public expenditure adding to inflationary pressures. The ministry of finance would estimate the absorptive capacity of the economy, and the remaining export revenue would flow into the natural resource fund. Timor-Leste has established such a fund.

Managing these measures simultaneously, limiting capital flight, monitoring private enterprises in the resource sector and creating a revenue overflow fund require close coordination among public sector agencies. Typical institutional responsibilities would be policing of capital controls by the ministry of finance (or the revenue authority if it is a separate institution), monitoring private enterprise reporting by the central bank, and placing the natural resource fund under autonomous management.

These measures initiate the basis for recovery by stabilizing the balance of payments, which reduces exchange rate instability. Exchange rate stability allows for the reversal of "dollarization", the use of internationally convertible currencies in domestic transactions in place of the national currency. Payments into natural resource fund further stabilize the currency and the external account.

If the government keeps public expenditure within the absorptive capacity of the conflict-reduced potential of the economy, recovery should be consistent with macro stability. This does not imply that the public sector balances its budget or even meets a deficit target. If private sector investment is extremely low, not unusual in post-conflict conditions, the level of government expenditure that achieves full potential may well imply a deficit. The goal of fiscal policy is not "consolidation" but stable, equitable and inclusive recovery. As mentioned earlier, if the composition is well balanced between productive and social expenditure, public debt would be sustainable through peace and growth dividends. On the other hand, excessive focus on very low inflation or fiscal consolidation may constraint social expenditure and job creation to the extent that it may jeopardize peace.

Macro policies for inclusive and sustained growth

The fundamentals of macro policies for inclusive and sustained growth are not too different from those during the recovery and stabilization phase. They still require a delicate process that requires flexibility in fiscal and monetary policy. But they have to guard against overheating and capital flights and ensure that public expenditure is directed towards both productive and social sectors in a balanced and efficient manner.

Once the post-conflict economy achieves macro-economic stabilization close to full potential output, policy should shift to achieving "orderly growth rate with *reasonable price stability*".[4] However, the focus should also be on the diversification of the economy and generation of productive and decent employment so that poverty is reduced among the conflict-impoverished population on a sustained basis. The government should use the growing export revenue to achieve these goals, including universalization of education and primary healthcare.

Monetary policy can support fiscal policy through use of the central bank rate to restrain credit. However, the central bank rate is not always an effective instrument. Attempts to constrain credit growth may result in dysfunctional high commercial bank rates that undermine productive investment. To complement a policy of moderately high interest rates, the central bank can employ instruments that act on the balance sheets of commercial banks and influence their capacity to expand credit. Regulation of reserves is a useful approach.

Monetary and financial policies must also improve financial inclusion and ensure financial sector stability. This would require careful financial sector reform that enhances access of SMEs and microenterprises to finance and strengthen prudential oversights. Public ownership of specialized financial institutions is found to improve financial inclusion. Countries should also consider setting up a specialized development bank to support industrial policy for diversification.

Once the economy recovers, exchange rate policy is straight-forward, preventing appreciation. With rising foreign exchange reserves, maintaining a stable exchange rate is a relatively easy task. Preventing appreciation is always easy because it involves accumulation of reserves. There is potential conflict between the central bank constraining credit growth and entering into foreign exchange purchases to manage the currency. As noted above, acting on commercial bank balance sheets is the mechanism to manage this conflict.

Macro policies for diversification

Economic diversification is the most challenging task for the resource rich countries. This is essential not only to improve dynamism and increase productive employment, but also to reduce their vulnerability to developments in global commodity markets

Overall fiscal policy plays the most important role. Public investment becomes the major instrument to promote the central policy objective of growth and diversification of the non-resource tradable sectors. Provision of infrastructure should focus on directly facilitating tradable production. One of the most frequent and obvious symptoms of a dysfunctional resource-rich economy is the construction boom. Investments in trade related transport and technical education to support agriculture and manufacturing are some of the alternative public investments that can foster tradables.

On the revenue side, policies need to focus on broadening the tax base and introducing direct taxes to reduce excessive dependence on resource revenue. This is essential not only for sustainable public expenditure, but also for reducing or preventing inequality. Reducing excessive inequality creates a virtuous cycle of increases in household incomes. This would enlarge the domestic market by raising consumption and stimulating labour demand. These, in turn, would increase income and public revenue.

In addition to public investment, government's procurement expenditure can also contribute significantly towards achieving the goal of employment creation and economic diversification towards sustainable non-resource sectors. As emphasized in the *Economic and Social Survey of Asia and the Pacific 2013*, government procurement expenses, because of their quantitative importance, have the potential to leverage the private sector to reduce adverse environmental impacts of production activities and to improve labour conditions. By buying from companies that have good labour standards and use employment-intensive sustainable production techniques, government can support their expansion.

Exchange rate and monetary policies play a supportive role. While slightly undervalued exchange rate promotes exports, favourable credit conditions for productive sectors, especially for SMEs, microenterprises and agriculture, are helpful for job creation and equitable growth with diversification.

Concluding remarks

This policy brief provides recommendations for the design of macroeconomic policy for resource-rich and conflict-affected countries. These countries have special characteristics. The feasibility and success of macroeconomic policy will depend on a policy design adapted to their specific needs and challenges. However, one thing is clear: the macroeconomic policy framework based on self-correcting market hypothesis and focused on pre-determined nominal targets, e.g, low single digit inflation and budget surplus or very low fiscal deficit may not be suitable for resource rich post-conflict countries. These countries need first to balance the need for macroeconomic stabilization with the need for sustaining peace and then focus on economic diversification, employment creation and human development. This requires flexibility afforded by the heterodox approach to macroeconomic policy making.

Endnotes:

[1] This draws on Hailu, Degol and John Weeks (2011), 'Macro-economic policies for growth and poverty reduction: An application to post-conflict and resource-rich countries', UN-DESA Working Paper, July 2011.

[2] See Tajgman, David and Jan de Veen (1998). "Employment-Intensive Infrastructure Programmes: Labour Policies and Practices" ILO, Development Policies Department, International Labour Office, Geneva

[3] For example, *Economic and Social Survey of Asia and the Pacific, 2010 & 2013* and MPDD Policy Briefs No.12

[4] This is in accord with IMF's Article of Agreement (IV).

The MPDD Policy Briefs aims at generating a forward-looking discussion among policymakers, researchers and other stakeholders to help forge political will and build a regional consensus on the needed policy actions and pressing reforms. Policy Briefs are issued without formal editing. For further information on the policy brief, please contact Dr. Anis Chowdhury, Director, Macroeconomic Policy and Development Division, ESCAP (escap-mpdd@un.org)

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