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Commodity Dependence: A Twenty-year perspective

by

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Seminar

Commodity Dependence: A Twenty-year perspective

Takeaways from the Report

- Reiteration of the dilemmas of commodity dependence and development. Commodity dependence is at the crux of the development challenges facing Africa.
- In terms of ***geographic region***, more than 80% of SSA are commodity dependent, and by ***development groups***, more than 80% of LDCs and LLDCs; and by ***income groups***, more than 90% of low-income countries.
- …Commodity dependence correlates *negatively* with levels of development, and *positively* with levels of vulnerability
- Commodity dependence in these groups of countries has not changed much over the two decades covered by the report: Rather, it increased slightly! So, it is much a problem today as it was two decades ago!
- Section 5 of the Report discusses the diversification experience various groups of countries over the period: energy/mineral dependent countries diversifying into downstream value-added products, and agricultural products, and in some limited cases into manufactured exports.

  This section could have benefitted from an insight into policy measures that underscored some of the observed trends or diversification.
- Commodity dependence reduces as a country climbs up the development ladder. - Only 32% of high-income countries are commodity dependent;
- Economic diversification and development are *positively* correlated. Diversification of production and exports promotes economic and social development, which is critical to developing domestic capabilities.

At issue? How can Africa structurally transform its commodity dependent economies?

What is "structural transformation"?

This entails a reallocation of activities across the three broad economic sectors of agriculture, manufacturing and services. That is, a shift of emphasis from a low productivity sector, such as agriculture, to higher and more labour intensity activities (manufacturing and services).
Central to this process is labour absorption and productivity improvements in the modern sector, and institutional improvements, all of which engender a higher, and more diversified, output.

This type of transformation, as argued by several economists, is a *sine qua non* for long term growth of per capita incomes; as it accelerates productivity, output and employment growth over time.

There are two processes involved:
(i) the sectors enjoying the highest rates of productivity growth and capacity expansion lead the innovation process and productivity gains; and,
(ii) the pattern of specialization shifts towards sectors benefiting from faster growth of demand (domestic and external), which in turn generates positive impacts on output and employment (Ocampo, et al, 2009; Herrendorf, et al, 2014).

Addressing the challenges to Structural transformation in African CDDCs.

1. Introduction

This is a developmental issue, which necessitates:
(a) macroeconomic, or economy-wide policy measures; and,
(b) sectoral/micro policies - that is, specific policies directed at specific sectors to diversify into higher value goods; and/or increase shares in value added.[1]

Three KEY words: "Vision, Innovation, Implementation" (VI^2) within a stable political system that guarantees policy consistency and/or predictability.

A. **<u>Economy-wide Policy measures</u>**

i. **Macroeconomic stability/fiscal discipline;** Counter-cyclical policies – SWFs
ii. **Savings and investment (FDI)**
iii. **Supply-side constraints (poor infrastructure, skill shortages, low levels of R&D)**
iv. **Institutional framework - *weak institutions, incl. legal-regulatory framework, SPS*, food safety & health standards;** *Tariffs* – rationalize and dismantle NTMs/NTBs; TBTs - critical element entailed in the functioning of R/GVCs is fragmentation of production across borders.
v. ***Intra-regional trade*** as a basis for RVCs, and GVCs – "Think regionally but act globally" Africa, 11%; Asia, 50%, LA & C, 21%; and Europe 70%

Regional approach would yield positive externalities.

Depending on the level of liberalization, the value of intra African trade could increase by 15-25% ($50-$70 billion) in 2040!

<u>Micro/Sectoral policies</u>

Holistic commodities strategy to cover both the agricultural and the extractive sectors despite the distinctive characteristic of each sub-sector, in order to ensure that the necessary *trade-offs and complementarities are considered* to ensure optimal outcomes for the sector.

Specific objectives of the strategy ("Smiley Curves")[2]
Africa should smile more broadly!

Left end of smile to right end: (Profits) (high industrial design, patents) – detailed engineering plan – manufacturing assembly, Branding and shipping – distribution, marketing, retail sales, service contracts, sales of parts and accessories, retail (profit).

[1] Much of what follows is based on Gayi, SK and JK Banini (2018) "Does Africa have what it takes to upgrade in Global Value Chains?", in Adewole, A and J Struthers (Eds*), Logistics and Global Value Chains: Impact on Trade and Development,* Palgrave, Macmillan

[2] *Applied to the manufacturing sector:* Product development from conception to sales "Value follows knowledge" (Developed in 1992 by Taiwanese Engineer, Stan Shi, founder of Acer)

"Value follows knowledge"

The ***agricultural sector***, at a broad level, would certainly benefit from polices that improve its efficiency or competitiveness:

- ✓ *Reduce informality* and introduce market institutions, partnering with the private sector (PPPs)
- ✓ *Introduce Complementary package of policies* (business training/advice/start-up loans) for small scale producers to transform their operations into businesses.
- ✓ Explore use of *Geographical Indications (GIs)* for local crop varieties for higher and stable prices – "**Pishori"** rice (Mwea, Central Kenya);
- ✓ Encourage horizontal and vertical diversification into new lines of economic activities, or value addition – e.g., cotton, cocoa, and lychees (premium wine/Mauritius).

Agricultural commodities whose *value chains are dominated by Transnational Corporations (TNCs)* (cocoa, coffee) may require policies that respond to their unique circumstances.

- ✓ Improve regulatory environment - Reinforce competition law and policy at the national (and international) levels;
- ✓ Enhance transparency in both local and international markets – input-output structure; GVC governance structure and the institutional framework, all of which are mediated by globalization
- ✓ Create opportunities and conditions (finance, training, JVs) for the emergence and development of small players/processors at the domestic level;
- ✓ Promoting product differentiation (GIs, "fine or flavour cocoa" for expensive, up-market, premium quality products) to enable farmers to benefit from higher and more stable prices. [23 countries approved by ICCO board in 2016 as producing Fine or flavor cocoa (mostly LA/Caribbean countries, only two from Africa (Madagascar, 100% & S Tomé & Principé, 35%)]

Minerals, Metals, and Energy (Extractive sector)

The GVCs of metals, ores and fuels do not easily lend themselves to the type of value addition and gainful upgrading that is common to agricultural commodities. This is because they are capital intensive and dominated by big mining conglomerates or TNCs.

Pursue a **"development linkages**" or "**local content development**" strategy
to establish economic links between TNC activities & domestic economy.

Policy thrust: Develop and promote the local private sector (SMEs,) to undertake subcontracting work for TNCs. This would normally entail engaging the private sector to provide "*producer services*" such as:

i. business and professional services (bookkeeping, accounting, catering, hotel/accommodation, etc),
ii. financial, banking and insurance services, and
iii. real estate services (architectural, engineering, electrical, etc).
iv. Oil field Services (OFS) for the energy sector – Geophysical, Drilling/Well services, and Marine and Transportation Services - covering the exploration, development, and production phases of the oil and gas industry. **Note**: ***Africa's market share only 4.8%!***

Equivalent to $7.6 bn (of $151 bn total in 2013); projected to increase to $17bn (of $300 bn total in 2019).

Critical to this is, *enhanced domestic R&D capacity* engineered through cooperation arrangements between governments and TNCs.
In time, this could evolve into the *supply of inputs by local entrepreneurs, and, then into capacities to provide upstreaming services such as innovation and design which would increase captured value at the domestic level.*

The *role of governments* is critical as some preconditions are a *sine qua non.*

- ✓ Stable macroeconomic conditions, infrastructure and power issues,
- ✓ Developing local innovation capabilities - vibrant private sector with strong entrepreneurial skills, and a skilled workforce,
- ✓ Incentivise TNCs (willing) to cooperate with government to achieve its objectives.

Where these *conditions are lacking*, governments would have to institute programmes that deliver them:

- ✓ Overhaul the educational, and technical and vocational training system (setting up apprenticeship and/or on-the-job training programmes), supported by R&D in a context of a ***national innovation system***.[3]
- ✓ TNCs could be brought on board through formal agreements/contracts, or informal ones based on nudging them towards these goals.[4]
- ✓ Contracts with TNCs could oblige them, *inter alia*, to: i. undertake. joint-ventureships (JVs) with local companies; ii. contribute to training funds; iii. transfer of technology, and in some cases iv. the use of "local content".

Note:
Namibia established the Petroleum Fund to train personnel for its energy sector;
Qatar established JVs and entrepreneurship development and training programmes with Total to kick-start of its petrochemical industry.
Indonesia - Industrial Linkage Programme (ILP) and
Malaysia the Vendor Development Programme (VDP).[5]

The two strands of the commodities development strategy could feed into a fully-fledged "Industrial Policy" in the medium to long term.

(a) ***Services sector:*** *moving from low to high value services*

Services are critical to sustained economic growth and transformation, and to the promotion of intraregional trade and GVCs. TiVA data base has revealed that the services content of exported goods is much higher than revealed by statistics on trade in services.

[4] The informal approach has been found to work quite well in some countries as it is based on trust between governments and TNCs and reduces or avoids legalities. However, whichever of these two approaches is adopted will depend on the political, social and economic context of the country.

[5] The objective of Indonesia's ILP is to develop domestic SMEs into competitive manufacturers and suppliers of parts and components and related services to TNCs which benefit from some fiscal incentives such tax incentives for limited period. Eligible SMEs are granted, among other benefits, investment tax allowance on qualifying capital expenditure incurred within a specified period. Malaysia's VDP has similar objectives. That is, to stimulate SMEs as reliable manufacturers and suppliers of industrial parts and components required by TNCs and large industries - so called "anchor companies" willing to participate; and growth through "industrial deepening" and import substitution. Participating SMEs must meet certain conditions – e.g., 70% local equity participation, and skilled workers with relevant experience.

Despite the growth of Africa's services sector in the last decade, it is still dominated by *informality and low value services at high cost*, hence the need for improving its efficiency.

Need to address structural impediments, including regulatory challenges, and prioritizing services in the AfCFTA. (African Continental Free Trade Area)

- ✓ "Producer services", intermediate inputs to further production activities sold to other firms, are critical for value chain participation.[6]
- ✓ : Address Trade Finance through new financial sector reforms that target competition and high cost in the sector.
- ✓ Improve legal and regulatory framework to promote Insurance services - indispensable for R/GVC participation as more and more firms sub-contract and would want to be protected in case of any default.

The WTO *Trade Facilitation Agreement* could be used to great effect in these areas.[7]

2. Concluding remarks

Investment, specifically TNCs (FDI) looms large in all these policy measures. But a word of caution - FDI is not equal to development/structural transformation

- FDI has costs and benefits; ***and its potential benefits are not automatically guaranteed for host economies.***
- FDI is a ***lag*** and not a lead variable in relation to growth and development
- **Threshold level** of skills, infrastructure and technology, etc, is required to reap the benefits of hosting foreign investors. (e.g., South Korea where government spending on research and development capabilities positively affected the impact of FDI).
- FDI can play a catalytic role if harnessed within a long-term and well-articulated development policy framework with clearly defined priorities (Thailand and Chile).

Task facing host country governments: how to *enhance the benefits* of FDI flows while *minimising associated costs* - more strategic thinking regarding FDI.

Development strategy should aim at creating a *more internally integrated economy, which reinforces external integration.*

Over the medium to long term, term, reducing Africa's commodity dependence will depend on shifting resources away from traditional low-productivity activities (eg. Agriculture) to more ***knowledge-based*** activities in manufacturing and services. This "structural transformation" will

[6] These include, business and professional services, financial services, insurance services, and real estate services. That is based on International Standard Industrial Classification (ISIC) Rev.

[7] Countries should be encouraged to use the Trade Facilitation Agreement Facility to conduct a "needs assessment". That is, to assess their capacity to implement, and in the process, identify their technical assistance needs. For example, what type of measures (Category A measures) should African countries notify to be implemented within one year of the Agreement coming into force? What of Category B measures – that is, provisions that the member will implement after a transitional period following the entry into force of the Agreement; and most importantly the assistance and support for capacity building required by Africa (Category C) in support of trade facilitation.

depend on adopting ***strategic industrial policies*** an integral part of which may be attracting a more dynamic type of FDI within a framework of a more robust domestic accumulation process. This will almost certainly require an enhanced "macro policy space". As the "Strategic component" (**not** favouring universal protection) would require, ***liberalization, protection, and subsidies* in various combinations**, depending on a ***country's resource endowments, macroeconomic circumstances and level of industrialization***. Recipients of the rents generated by such interventions must be disciplined through the enforcement of effective **time limits and performance requirements**.

Recap…

- *Get economic fundamentals right*
- *Promote trade within a regional economic cooperation framework*:
- *Develop a viable private sector* supported by a **national innovation system**
- *Implementation, implementation, implementation!* as a process of evaluating progress being made and feeding the results of this evaluation into improvements to the programme.

3. Two Closing thoughts – "Postscript"

a. **International policy measures** within a context international commodity governance architecture? Have we given up on such issues as?

- Commodity prices/remuneration; Price stabilization measures (?)
- Reform of International taxation measures, Transfer pricing (OECD);
- Addressing trade misinvoicing – e.g. how to curb with developments in ICT (Blockchain technology)?
- Governance structure of GVCs

b. **"Unknown unknowns"** à la Donald Rumsfeld! (Defence Secretary under George W Bush)

Technological advances, such as sewbots, advance robotics, and 3-D printing - latter projected to advance enough to cut international trade by 50% in 40 years. What are the implications of these for Africa's structural transformation agenda?