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**Managing Boom-Bust Cycles in
Commodity Dependent Economies**

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MANAGING BOOM-BUST CYCLES IN COMMODITY DEPENDENT ECONOMIES

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THE STORY

- Decade-long commodity boom (super-cycle) appears to be coming to an end.
- Boom accompanied by highly favourable global financial conditions. But this is also changing. Financial conditions tightening; even tighter in the coming years.
- Similarity with 1970s-80s. 1970's boom was also associated with easy global financial conditions (recycling of petro-dollars, low rates). Commodity collapse occurred alongside a hike in rates (Volcker), leading to LA debt crisis.
- The outcome this time may not be as bad:
 - Commodity and financial shocks are likely to be less severe.
 - The boom somewhat better managed than in the 1970s.
- Still, occasion not used to reduce commodity dependence and macro defences built are inadequate. Should downswing persist, the damage can be serious for countries with weak fiscal and current account positions, large build-up of external debt and a high degree of commodity dependence.

THE COMMODITY BOOM AND DOWNTURN

- The boom:
 - Price increases faster and steeper than previous booms;
 - Broad-based: co-movement among commodities is greater than in the past
- Post-Lehman recovery followed by a downturn, first in non-oil then in oil. Sharp drops from peaks, but prices still well above 2003. May see further drops. Historically rapid increases always followed by sharp drops.

COMMODITY AND FINANCIAL CYCLES

- Commodity cycle is strongly correlated with financial cycle (capital inflows) (**Chart**). Strong interaction between commodity and financial markets; reinforcing each other in both expansion and contraction in several ways:
 1. Financialization of commodity markets; trading in commodity derivatives accentuating swings.
 2. Low interest rates boost demand for storable commodities and dampen supply of minerals and oil by reducing the rate of extraction and exploitation.
 3. Strong inverse correlation between the dollar and commodity prices.
 4. Strong inverse correlation between commodity prices and sovereign credit spreads. Rising prices and falling spread stimulate capital inflows into commodity EDEs through lending and investment.

MANAGING THE BOOM: THE POLICY CHALLENGE

- Extended booms give opportunity to raise investment to improve infrastructure and reduce commodity dependence. How to do this when the incentive structure disfavours industry (currency appreciations and Dutch Disease)?
- Need to provide for the downswing by creating fiscal surpluses, stabilization funds, and international reserves and by reducing debt. How to balance this macro objective (stabilization of activity over the cycle) with the need to invest for structural transformation during the boom?
- Save-spend dilemma often aggravated by pressures to increase social spending to reduce poverty; but can it be sustained in downswings (poverty now up in LA)?
- Uncertainty over how far the boom would last; how permanent the upswing.
- Management of boom is more difficult when associated with a financial bubble

MONETARY POLICY, EXCHANGE RATES AND RESERVES

- Real appreciations due to rising price level and forex glut (nominal appreciation); reinforced by capital inflows and private borrowing encouraged by rising prices.

- Appreciations and rising incomes create consumption and import booms; and damage industry (deindustrialization). Also encourage borrowing in forex.
- Monetary policy faces dilemmas in managing external and internal values of the currency; tightening to check inflation attracts arbitrage flows; incomes policy?
- Sterilized interventions and reserve accumulation as self-insurance; exposure to commodity shocks a key determinant of reserve adequacy.
- However, interventions are costly; may need direct controls over portfolio inflows and private borrowing abroad.

EXCHANGE RATES AND RESERVES: THE RECORD

- REER appreciations more moderate than 1970s. Still widespread (Angola, Brazil, Chile, Colombia, Indonesia, Nigeria, Russia, RSA, Venezuela and Zambia). By 50% or more in some.
- Many (Brazil, Chile, Colombia, Indonesia and Peru) raised interest rates for fear of inflation, making it difficult to manage currency. Reluctance to control inflows and private borrowing; allowed nominal appreciations or used interventions
- Reserves increases widespread. But large variations in their source and hence in vulnerability to reversal of prices and capital inflows:
 - In 9 out of 22 cases reserves earned from export (current account – CA) surpluses.
 - In 8 countries CA remained in deficit and reserves came entirely from capital inflows; borrowed reserves.
 - In 5 reserves were partly earned, partly borrowed.

COMMODITY BOOMS AND FISCAL POLICY

- Booms generate higher fiscal revenues through royalties, corporate taxes and incomes of SOEs in minerals and oil; and taxes on producers and traders in agricultural commodities. They also reduce certain non-discretionary spending (automatic stabilizers linked to social protection)

- Cyclical improvements in the budget do not imply that fiscal policy is counter-cyclical. Need to look at structural balances.
- Countercyclical policy:
 - Raise taxes on commodity producers and traders and renegotiate royalties to capture part of windfalls to augment revenues for investment and stabilization funds. Do not be tempted to cut other taxes.
 - Balancing two competing needs (macroeconomic stability over time and structural transformation) calls for a judicious combination of public savings and investment, depending on the state of the structural budget.

FISCAL POLICY: THE RECORD

- Budget balances improved until 2008, then worsened (policy response to crisis)
- Fiscal policy generally pro-cyclical, but less than 1970s. Primary spending/GDP rose in most countries; policy strongly pro-cyclical in oil and mineral exporters.
- In major oil exporters in SSA, non-oil fiscal deficits increased from 27% of non-oil GDP in 2003 to 38% in 2008.
- In LA structural primary balances weaker than actual balances; only a few (Chile) was in structural surplus (IDB/WB/IMF/CEPAL).
- New stabilization (resource) funds set up during boom (Angola, Chile, E. Guinea, Nigeria, Russia, T&T, Venezuela); but not always delivering
- Windfalls for TNCs, but most EDEs had no clauses in BITs to renegotiate royalties. Some (Bolivia, Ecuador, Venezuela, Botswana) managed to do so.

THE COMMODITY BOOM AND DEBT

- Aggregate public debt ratios came down in most commodity exporters. But some notable exceptions; Malaysia, Mexico, South Africa and Zambia.
- International borrowing fell in most EMEs; many turned to domestic bond markets, opening them to non-residents and borrowing in local currency. Currency mismatch reduced but new vulnerabilities (SCRIP 60)

- Significant private external debt build-up in EMEs; commodity sector among largest debt issuers. Oil and gas sector debt increased from \$1tr in 2006 to \$2.5tr in 2014. Such debt grew at 25% per annum in Brazil and 13% in Russia.
- Low interest rates and spreads and ample global liquidity led many commodity economies typically dependent on official lending go to international bond markets; first-time bond issues (Bolivia, Ecuador, Ethiopia, Gabon, Ghana, Nigeria, Rwanda, Senegal, Tanzania and Zambia). Downswing can create debt-servicing problems.

SAVINGS, INVESTMENT AND EXTERNAL GAP

- Optimum response: raise investment while improving the CA (raise savings faster than investment) so that when prices soften and the CA worsens, a relatively high, albeit reduced, level of investment could be maintained. This was not the case in 1970s; when prices collapsed, so did investment.
- Savings and investment increased in most during 2002-08; still very low in some (Brazil and RSA)
- CA worsened in many despite price boom (Argentina Brazil, Chile, Colombia, Peru, Venezuela, Congo, Ghana, Tanzania, Russia and Indonesia). In LA in 2008 recorded CA was balanced, but in deficit by 5% of GDP if adjusted for TOT.
- Only a few managed to improve savings, investment and the CA (Algeria, Angola, Bolivia, Ecuador and Nigeria). In such cases when prices fell after 2011, CA deteriorated but remained at manageable levels while investment kept up.
- Not much investment in non-traditional industries in SSA or LA. Concentrated in commodity and non-traded (property) and infrastructure. Falling industrial employment and deindustrialization (Brazil, Russia, South Africa).

CONCLUSIONS

- Recent boom somewhat better managed than 70s; price uncertainty now greater?
- SSA done better than LA where growth now is not expected to exceed 1%
- Fiscal policy generally procyclical before 2008; countercyclical in some during crisis (2009-10). Now most countries entering downturn without fiscal space.

- Capital inflows and currency appreciations now reversed; can hurt countries with large build-up of debt in recent years (public debt in LICs and private in MICs)
- Investment levels seen during the boom not sustainable, since structural savings and forex gaps remain. As prices fall and CA deficits widen, burden would fall on investment.
- Hopes that commodity downturn short-lived and financial tightening gradual. But risk of extended period of sluggish and erratic growth.