

Is a 'Resource Curse' Inevitable in Resource-Rich Countries?

Comparing Policies in Azerbaijan and Zambia

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It is generally recognised that during export booms, resource-rich countries can often face the problem of upward pressure on their nominal exchange rate, which is typically combined with inflationary pressures that worsen the tendency to real appreciation. Both problems require coordinated macroeconomic management to contain any negative effects.

It is also extremely important that fiscal policies be designed to reap the benefits of a boom in revenue in order to finance public investment and support private investment. Too many resource-rich—and otherwise poor—countries have handed out lavish tax concessions in order to attract foreign investors.

Coordinating exchange-rate and monetary policies is crucial. Floating exchange-rate regimes and restrictive inflation-targeting monetary policies are usually counter-productive in such a context. And trade liberalisation and open capital accounts only make matters worse.

Because of the pressure for currency appreciation, managing the exchange rate is particularly important. Also, since expectations of appreciation can encourage short-term speculative capital inflows, a useful policy complement is capital-account regulation. In such a context, raising interest rates to dampen inflation could intensify such volatile inflows.

Combining deregulation of the capital account and a floating exchange rate with monetary policies that are fixated on maintaining low inflation is a recipe for a Dutch disease disaster. Yet, it is precisely these worst-case options that orthodox macroeconomic policy often insists on adopting.

Contrasting Experiences

In order to illustrate such policy options, we contrast the experience of two low-income countries, Azerbaijan and Zambia. The first has sizeable reserves of oil and the second large deposits of copper.

New oil reserves were discovered in Azerbaijan in the 1990s, leading to an increase in production from less than 200 barrels a day in 1997 to over 800,000 in 2007. Its peak production is expected to be over two million barrels a day during 2010-2020, placing it among the top ten net exporters of oil.

As a result of rapid increases in oil exports beginning in the late 1990s, Azerbaijan's currency, the Manta, began to appreciate, with rising inflation aggravating the process. Such trends threatened to precipitate a decline in the profitability of non-oil tradables and undermine their employment impact.

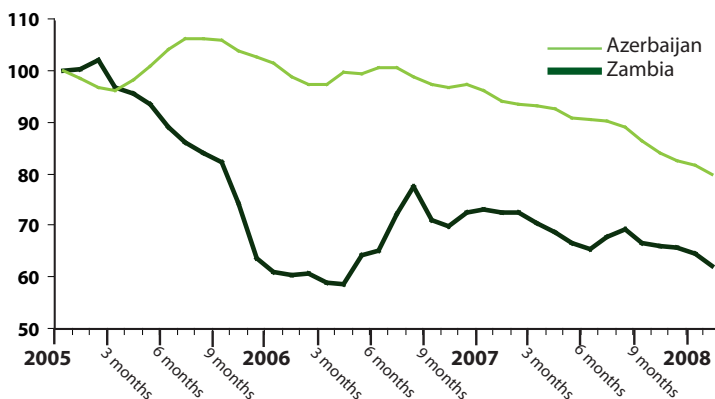
Despite these emerging problems, IMF experts in 1998 still advocated a floating exchange rate, a focus on inflation targeting and an open trade regime (Rosenberg and Saavalainen, 1998). Fortunately, the government of Azerbaijan did not follow such advice, maintaining some non-tariff barriers, for instance, in order to regulate trade. Such IMF advice would have undermined the growth of employment in the tradable sectors, replacing, for example, domestic agricultural production with cheaper food imports.

The Resource Boom

After 2004, world petroleum and copper prices more than doubled. While both Zambia and Azerbaijan suffered from adverse effects, Azerbaijan was able to moderate them through heterodox policies. It pursued capital controls and a fixed exchange rate (first to the U.S. Dollar, later to the Euro). In contrast, Zambia had no capital controls, lowered trade tariffs and adopted a flexible exchange rate (see Weeks et al. 2007).

Real Exchange Rates, Zambia and Azerbaijan, 2005 - 2008

Trade-weighted average of US\$ and Euro (2005=100)



Sources: Bank of Zambia and National Bank of Azerbaijan.
Note: a lower index indicates higher appreciation

In nominal terms, Zambia's exchange rate appreciated by 15 per cent in the first quarter of 2008 compared to its level in the first quarter of 2005. This was over 35 per cent in real terms (see Figure). During the same period, Azerbaijan's currency depreciated nominally by just over 10 per cent while its real appreciation, because of rising prices, was 18 per cent (see Figure). This degree of appreciation was about half that in Zambia even though Azerbaijan's inflation rate was slightly higher than Zambia's.

In Zambia, the IMF and the World Bank made a number of critical mistakes in their policy recommendations. During the 1980s, the country's copper production fell dramatically, almost to zero in the early 1990s. Meanwhile, radical trade liberalisation contributed to the collapse of its domestic manufacturing. With copper employment approaching nil and manufacturing jobs disappearing, urban poverty in one of Africa's *least* rural countries rose dramatically.

During the 1990s, a process of copper privatisation began, managed by the World Bank. The privatisation sales included extremely liberal tax exemptions, implying that any ensuing recuperation in copper prices would generate little revenue for the public sector. However, copper prices did recover, beyond the wildest hopes of the companies, but this occurred in the worst possible context for the government.

Policy Mistakes in Zambia

As indicated in the Figure, the boom in prices caused a substantial appreciation of the Kwacha, which, combined with a liberalised trading regime, served to undercut agricultural production. Simultaneously, the zealously pursued anti-inflationary policy of the central bank limited access to credit. This constrained growth in the non-copper sectors of the economy as well as blocked effective interventions in the foreign-exchange market to dampen appreciation.

While Azerbaijan's contracts with foreign companies ensured a robust inflow of revenue such that the government had no binding budget constraint, Zambia's government received little fiscal benefit from the copper boom and thus had to operate under severe expenditure limits set by the IMF.

If ever there was a failure foretold, it was in Zambia after 1990. A government suffering from a severe revenue constraint was pressed to accept copper privatisation that liberated companies from taxation. Moreover, a country that had an underdeveloped agricultural sector, due originally to the colonial division of labour in British Central Africa, found itself operating with the lowest agricultural tariffs in the region.

Zambia's high interest-rate monetary policy ensured that productive investments would be unprofitable if financed domestically. And, finally, a rapidly appreciating exchange rate not only undermined non-copper tradables but also substantially reduced the domestic currency equivalent of the major sources of government income, namely, trade-related taxes and official development assistance.

The contrasting experiences of Azerbaijan and Zambia suggest that if such countries suffer from a 'resource curse', the spell is not necessarily cast by inexorable forces, but by seriously misguided economic policies. And for the curse to be lifted, such policies have to be abandoned.

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