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Challenges, Policy Options, and the Way Forward

Economic Diversification in Selected Asian Landlocked Developing Countries (Bhutan, Kazakhstan, Mongolia, and Turkmenistan)

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EXECUTIVE SUMMARY

Landlocked developing countries (LLDCs) face multiple development challenges. On the one hand, they incur higher trade costs due to their geographical remoteness, inadequate transport infrastructure, and poor trade logistics. These problems are compounded by the challenges of multiple border crossings and diverging transport systems and regulations in transit countries. On the other hand, many LLDCs lack crucial productive capacities and are dependent on the exports of primary commodities, rendering them vulnerable to global commodity price shocks.

In 2014, the Second United Nations Conference adopted the Vienna Programme of Action for LLDCS for the decade 2014–2024 (VPoA) to address these trade and development challenges. In 2019, five years into implementation of the VPoA, the General Assembly will undertake a comprehensive midterm review of its progress pursuant to resolution UNGA 72/232. Preliminary assessments of progress, including by the United Nations Conference on Trade and Development (UNCTAD), show that, five years into the implementation of the priority areas contained in the VPoA, the socioeconomic conditions of LLDCs have not shown significant improvements.

This report forms part of UNCTAD's substantive contribution to the midterm review of the VPoA. It examines the micro- and macro-economic policies as well as the institutional and regulatory measures required to promote economic and export diversification in four Asian landlocked economies: Kazakhstan, Turkmenistan, Mongolia and Bhutan. The four countries are characterized by high levels of commodity-dependence, challenging geographical and historical contexts, and low socioeconomic outcomes.

The report argues that, despite complex trade and development challenges, the countries studied have significant potential to diversify their economies into the production and export of higher-value-added products in several sectors. These include agriculture (including agro-processing), light manufacturing (such as textiles, leather, and leather products), information and communications technology, tourism, and the construction sectors. Using the product-space approach, the report also identifies specific products that hold potential for export expansion and diversification in each country. For instance, agriculture and, to a lesser extent, manufacturing, are promising sectors for diversification, including niche products such as mandarin oranges (Bhutan), cashmere (Mongolia), silk (Turkmenistan), and cereal (Kazakhstan). The rich cultural heritage and varied geography of these countries are also conducive to tourism. In addition, there can be synergies between tourism and improvements in the quality of some local food and manufacturing products. However, a number of improvements in micro- and macro-economic policies and institutions are necessary to realize this potential.

I. INTRODUCTION

There are 32 countries classified by the United Nations as landlocked developing countries (LLDCs): 16 in Africa, 14 in Asia and Europe, and two in Latin America.[1] As the name of the group indicates, they all share two particular features: they are developing countries, and they do not have direct access to a sea. Otherwise, they differ in many respects. Their populations range from less than 1 million to more than 100 million. The income level of the poorest LLDCs is below US$1,000 at purchasing power parity (PPP), while that of the richest is above US$10,000, although most LLDCs are categorized as either low-income or middle-income countries. Despite their differences, many LLDCs share stark similarities along plenty of socio-economic dimensions that go beyond their lack of sea access. One such defining feature is considerable reliance on just a few natural resources, i.e. commodity dependence. For instance, in 2016 more than half of all export revenues in 22 LLDCs came from only three products.[2] In addition to this dependence on a few commodities, many of these countries are also reliant on a few large markets such as China, the European Union (EU), India, the Russian Federation, and the United States. Furthermore, LLDCs are characterized by poor transport infrastructure and trade logistics, as well as cumbersome trade facilitation processes, all of which substantially increase their trade costs and undermine their international (i.e. export) competitiveness.

The communalities of complex development challenges facing LLDCs are causes and consequences of severely underdeveloped and weak productive capacities,[3] lack of export diversification and absence of structural economic transformation.[4] Building on its conceptual and analytical work, the United Nations Conference on Trade and Development (UNCTAD) argues that the key to address

1. Afghanistan, Armenia, Azerbaijan, Bhutan, Bolivia, Botswana, Burkina Faso, Burundi, Central African Republic, Chad, Ethiopia, Eswatini, Kazakhstan, Kyrgyzstan, Lao PDR, Lesotho, Malawi, Mali, Moldova (Republic of), Mongolia, Nepal, Niger, Paraguay, Rwanda, South Sudan, Swaziland, Tajikistan, the Former Yugoslav Republic of Macedonia, Turkmenistan, Uganda, Zambia, and Zimbabwe.

2. At the 3-digit level of the SITC, Rev. 3.

3. Productive capacity is defined by UNCTAD as "the productive resources, entrepreneurial capabilities and production linkages which together determine the capacity of a country to produce goods and services and enable it to grow and develop" (UNCTAD 2006: 61). The definition stresses three distinct but interrelated dimensions – productive resources, entrepreneurial capabilities, and production linkages – that make up the fundamental elements of productive capacity.

4. Structural economic transformation, which is Priority 5 of the Vienna Programme of Action, refers to the movement of productive resources and policy actions from low-productivity economic activities to higher-productivity ones, and from traditional to modern sectors, with increasing value addition and sophistication of export products and services. Structural economic transformation can occur not only across sectors but also within sectors.

1.1 The paradox of natural resource wealth in the Central and South Asian context and prospects for economic diversification

One would expect natural resource abundance to be a great advantage in fostering prosperity in developing countries, given the right policy, institutional, and regulatory environments that support productive and transformational development. In practice, more often than not, natural resource wealth has proven to be a factor inhibiting rather than facilitating or promoting economic development (Venables 2016; Collier 2007). The growth performance of natural-resource-abundant countries has generally been lackluster, as Sachs and Warner (1995) were the first to point out. In the 2000s, the "commodity super-cycle" of rising commodity prices driven by Chinese demand for raw materials, particularly energy, led to booming growth in many natural-resource- exporting countries (Gangelhoff 2015). Falling oil and other commodity prices since 2015, associated in part with a slowdown in China's growth, has revealed the fragile foundation of this growth and the lack of structural transformation in many natural resource exporters, with many countries facing fiscal and balance of payments crises and sharp declines in growth.

There are a number of economic and political reasons for the gap between natural resource wealth and socio-economic development. From an economic point of view, natural resources are difficult to manage (Venables 2016). Extraction is often technically complex and beyond the capabilities of developing countries. Thus, many countries welcome foreign investment. Relations between multinational companies and national governments can be fraught, and in some cases developing countries may not bargain effectively or lack the capacity to do so. In other cases, developing countries are so wary of foreign involvement that they prohibit or dissuade it, thus reducing their ability to exploit and earn income from their resources. This is the case with Turkmenistan for natural gas and Mongolia for mining, as discussed below.

Moreover, management of resource revenues has proven to be the most significant problem. First, resource prices and revenues are highly volatile, making planning difficult. In principle, countries should save a large part of their income when prices and sales are temporarily high, perhaps into a stabilization fund, and thus run current account and fiscal surpluses. Conversely, when prices are below their long-run level, countries can legitimately run fiscal and current account deficits. In practice, however, even ignoring the political distortions discussed below, it is not always easy to determine when prices are above or below an equilibrium level and whether price changes are permanent or temporary. Second, booming natural resources tend to result in "Dutch disease" – domestic currency appreciation and higher wages – that harms other tradable goods sectors, both traditional and non-traditional. This can be problematic for long-run development because of the acute dependence that results on one or a few commodities. Third, even when windfall revenues are used for investment rather than consumption, the investments sometimes support showcase monuments or inefficient public sector enterprises that do not contribute to long-run growth. Finally, and perhaps most importantly, natural resource extraction and distribution is capital-intensive and not conducive to shared growth and structural transformation.

Manufacturing and agriculture contribute more to technological progress, forward and backward linkages with other sectors, and employment creation, including for women and youth. The employment issue is of critical importance in countries with young and rapidly growing populations, and empowerment of women is of central importance in its own right as well as a way of fostering the demographic transition to lower birth rates. The so-called "East Asian miracle" was based on export-led growth of labor-intensive manufacturing. Export-oriented agriculture, fishing, and tourism can also play a transformative role for much the same reasons: employment creation and quality upgrading through participation in global value chains (Golub et al. 2008; Golub et al. 2011). Even when they were growing rapidly in the 2000s, many commodity-exporting countries such as Angola experienced very high levels of inequality and widespread underemployment (Golub and Prasad 2016).

While these economic downsides of natural resource dependence are important, economists increasingly recognize that the political, regulatory, and institutional consequences are even more crucial. The problem is simple: large resource rents (i.e. revenues in excess of costs) can provide an irresistible temptation to engage in wasteful spending and corruption. It is difficult to restrain spending when revenues are high, even for well-intentioned officials who recognize the temporary nature of price increases. Worse, with weak institutional restraints, resource rents occasion rent-seeking, i.e. battles over access to these rents. They also lead to patronage and corruption, sometimes even contributing to civil conflict and state failure (Collier 2007, 2010). Thus, revenues are often used by ruling elites in both democracies and dictatorships to enrich themselves and their families while buying support from the population with costly and inefficient subsidies. For example, some oil-exporting countries such as Nigeria have very low domestic prices of refined petroleum products, so much so that their refineries are bankrupt and the countries have to import gasoline, some of which is smuggled from neighboring countries with lower subsidies and thus higher prices.

Furthermore, international financial markets may abet procyclical fiscal policies by providing abundant loans in good times while pulling out abruptly when prices fall (Vegh 2015). Offshore financial markets also contribute to corruption by accepting and concealing plundered funds from elites in developing countries. Finally, corruption and fiscal irresponsibility are facilitated by off-budget management of resource revenues, often in the guise of a stabilization fund (Venables 2016).

Misuse of resource revenues and institutional dysfunction can go hand-in-hand in a vicious circle. Countries with weak institutions find it most difficult to prevent corruption or the wasteful use of revenues. Conversely, resource revenues can perpetuate institutional failures and poor policies by easing budget constraints and thus enabling avoidance or postponement of necessary reforms.

1.2 What can be done?

Reducing dependence on natural resource revenues involves both macroeconomic and microeconomic policies, as well as strengthening the governance and institutional capacity to implement such policies. It also requires fostering productive capacity, structural transformation, and diversification of exports, as well as clearly understanding market requirements and demand structures in export destinations.

1.2.1 Macroeconomic policies

It is important to follow countercyclical spending policies, that is, saving resource revenues in boom times and reserving deficit spending for downturns in revenues. When prices are high, countries should run fiscal and current account surpluses, reducing public debt and accumulating foreign exchange reserves. As noted above, this is difficult due to political pressures to ramp up spending when revenues are high and credit is readily available. Establishing stabilization funds governed by spending rules can be a positive step, but only if these funds are operated transparently and the rule of law is followed. In addition to saving from windfalls, investment spending on infrastructure, education, and other projects that boost long-term development can be justified, but the investments must be driven by economic returns rather than political favoritism. Limiting real exchange rate appreciation is also important to mitigate Dutch disease effects. Accumulating foreign exchange reserves during booms can reduce pressure on the exchange rate to appreciate in both nominal and real terms. Countercyclical spending policies also are helpful in reducing appreciation.

A few countries, such as Botswana (Kojo 2016), have been quite successful in managing revenues. Botswana leveraged its diamond revenues into very rapid growth and poverty reduction by following the above principles: countercyclical fiscal policies, limited real exchange rate appreciation, and well-targeted investments in infrastructure, health, and education. Strong institutions and control of corruption are the keys to these relatively few success stories, although Botswana still struggles to reduce its dependence on a single export item (diamonds).

1.2.2. Structural policies to spur diversification

While sound macroeconomic management of resource revenues is necessary, it is also critical to create the downstream sectors such as petrochemicals and metals are capital-intensive and require a high level of technical sophistication. Conversely, labor-intensive manufacturing may be viable even if the country does not produce the raw material in question, as East Asian countries have demonstrated. The East Asian experience also suggests that low-income countries should start with the least-skill-intensive products and gradually upgrade their production capabilities and the sophistication of their exports (Golub et al. 2008).

Increasingly, diversification into manufacturing and agriculture requires participation in global value chains. Multinational producers and buyers seek the most favorable locations for production of components or niche products (Pomfret and Sourdin 2014). Such factors as well-functioning infrastructure, limited administrative red tape, transparency of government operations, and labor with appropriate skills determine whether a country can gain a foothold in manufacturing global value chains. As Golub et al. (2007) put it, the quality of a country's "service links" (ports, roads, customs administration) affect the competitiveness of its "production blocks". For agriculture, fishing, and tourism, local determinants of comparative advantage such as climate, soil conditions, and historic patrimony matter more, but these sectors are also very competitive and success depends on quality control as much or more than in manufacturing (Golub et al. 2008; Golub and McManus 2009; Golub and Varma 2014).

The difficulty of participating in global value chains is exacerbated in resource-rich countries for the reasons mentioned above. Furthermore, the countries considered here, as summarized in the next section, have a history of central planning and isolation from the global economy. For these reasons, this report pays particular attention to