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Special Focus

Investment weakness in commodity exporters

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Investment growth in commodity-exporting emerging market and developing economies (EMDEs) has declined sharply since 2010, and was below its long-term average in about two-thirds of these economies in 2015. This slowdown reflects weak growth prospects, elevated uncertainty, deteriorated terms of trade, and increased private debt burdens, among other factors. Policymakers face weakened fiscal positions and generally above-target inflation levels and therefore have limited macroeconomic policy space to reignite investment growth.

Introduction

Investment growth in commodity-exporting EMDEs has also slowed substantially, falling from 7.1 percent in 2010 to 1.6 percent in 2015 (Figure F1). In about two-thirds of commodity-exporting EMDEs, investment growth was below its long-term average in 2015. Weakness in investment has been broad-based and includes both public and private sources (Figures F2).

Subdued growth prospects and deteriorating terms of trade, compounded by rising political instability, contributed to the investment slowdown. The fall in commodity prices, for instance, accounts for 1.5 percentage point of the total decline in investment growth in commodity exporters between 2011 and 2015. A 10 percent increase in VIX volatility index is associated with a 0.5 percent decline in investment growth within a year in these countries. Weakening investment occurs at a time when many of these economies have major investment needs, especially in the areas of health, education, infrastructure, and urbanization (World Bank 2017).

Despite stabilization in commodity prices over the course of 2016, a double-digit cumulative decline from early-2011 peaks created a major terms-of-trade shock for commodity-exporting EMDEs. A number of them are still struggling to adjust to the prospects of continued low commodity prices. GDP in commodity-exporting EMDEs is estimated to have grown by 0.3 percent in 2016, well below the 5.6 percent pace of commodity-importing EMDEs.

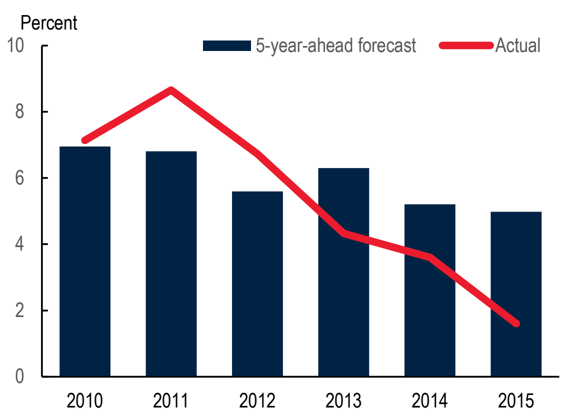
Against this background, this Special Focus section addresses the following questions: (1) How has investment growth in commodity-exporting EMDEs evolved? (2) What are the sources of the investment slowdown in commodity-exporting EMDEs? (3) Which policies can help reignite investment growth?

How has investment in commodity-exporting EMDEs evolved?

During 2003-08, investment growth in commodity-exporting EMDEs reached historic highs, averaging 11.7 percent per year, more than twice the long-term average growth rate of 4.6 percent. The investment boom in commodity exporters reflected soaring commodity prices, which encouraged investment in resource exploration and development and, in anticipation of higher future incomes, non-resource projects (World Bank 2016).

However, investment growth in commodity exporters slowed steadily from 7.1 percent in 2010 to 1.6 percent in 2015. The deceleration was even more pronounced among energy exporters, where investment

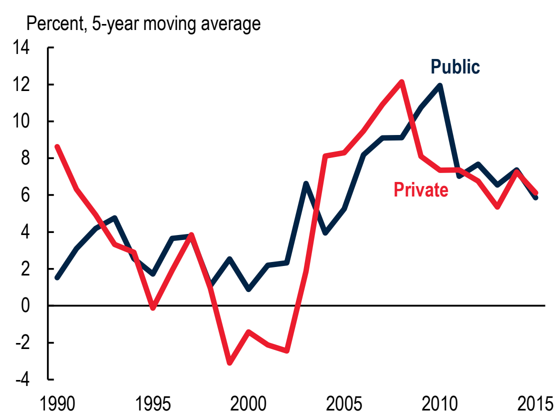
F1 Actual and 5-year-ahead forecasts of investment growth



Source: International Monetary Fund.

Notes: Each bar shows five-year-ahead Consensus Forecasts as of the latest available month in the year denoted. Unweighted averages of 10 commodity-exporting EMDEs.

F2 Investment growth in commodity-exporting EMDEs



Source: World Bank.

Notes: Weighted averages. Long-term average starts in 1991 for EMDEs due to lack of earlier data. The sample includes 83 commodity-exporting EMDEs.

eased from 8.9 percent in 2010 to 1.8 percent in 2015. Since 2013, investment growth has been well below its pre-crisis 2003-08 average rates, which were in the double digits, and below its long-term average over 1990-2008. Five-year-ahead forecasts of investment growth have also continuously declined over the last five years. The share of commodity exporters experiencing investment growth below its long-term average rose from 40 percent in 2010 to 67 percent in 2015 (Figure F3). Investment weakness has affected all types of activities, including machinery, equipment, and construction, and both public and private sources, particularly public ones. Investment in resource-intensive sectors has closely followed the decline of commodity prices, as reflected in weak oil and metal company investment in exploration and extraction globally (IMF 2015a, 2015b). Various studies have shown that commodity price movements and investment in commodity exporters are closely tied (Fornero, Kirchner, and Yany 2016; Cespedes and Velasco 2012; Kose 2002).

In commodity-exporting EMDEs, private investment during 2010-15 accounted for roughly 78 percent of total investment. Some of these countries unwound fiscal stimulus only slowly in 2008-09 as public investment growth remained positive despite a slowdown during 2010-13. Since 2013, however, public investment growth in commodity exporters has dropped sharply and shrank in 2015. In contrast, private investment growth has slowed more gradually from its post-crisis peak in 2010, a tentative stabilization in 2015 notwithstanding.

Post-crisis investment weakness in commodity-exporting EMDEs occurs against a global macroeconomic backdrop which includes stagnant trade and heightened policy uncertainty. Conditions should improve, however, in light of the expected recovery in commodity prices. In addition, possible fiscal stimulus in key major economies and potential positive spillover effects to other economies represent an upside risk to the global outlook (World Bank 2017).

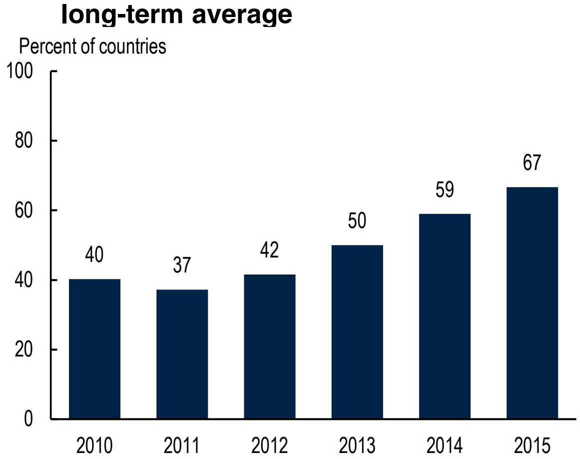
What are the sources of investment growth slowdown in commodity-exporting EMDEs?

Headwinds to investment include weak growth prospects, severe adverse terms-of-trade shocks, rapid accumulation of private debt, and recently, heightened policy uncertainty in major economies.

Weak GDP growth prospects

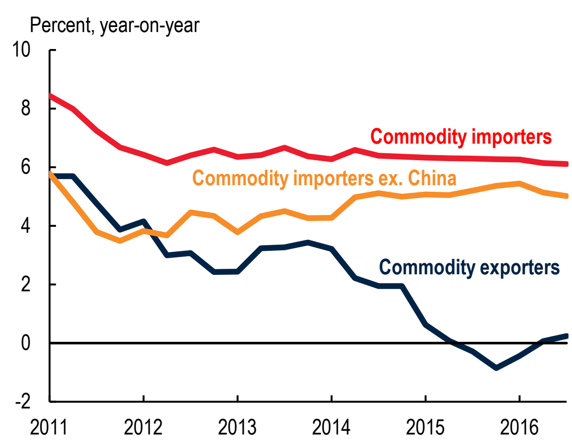
Output growth in commodity-exporting EMDEs has slowed since the financial crisis, dropping from 8.9 percent in 2011 to 0.4 percent in 2015, levels well below the pre-crisis average (2003-08) of 11.5 percent (Figure F4). Among commodity-exporting EMDEs, weak growth prospects during the last two years has been more pronounced in energy exporters (Figure F5). Decelerating output growth prospects accounted for about 1.3 percentage points of the slowdown in investment growth in commodity exporters since 2011. Growth prospects in these economies have been dampened by a deteriorating outlook for major economies that are important trading partners, as well as sluggish productivity growth and demographic factors. In particular, growth in China has slowed in the face of weak external demand and policy measures aimed at shifting economic activity from manufacturing to services. This has reduced global commodity demand and generated adverse spillovers to commodity-exporting EMDEs (World Bank 2016).

F3 Countries with investment growth below long-term average



Source: World Bank.
Notes: Long term averages are country-specific and refer to the period 1990-2008. The sample consists of 78 commodity exporting EMDEs.

F4 GDP growth



Source: World Bank.
Notes: Weighted averages of GDP growth. Last observation is 2016Q2.

Worsening terms of trade

As a result of the sharp commodity price slide from early-2011 peaks, the terms of trade—the ratio of export prices to those of imported goods and services—of commodity exporters deteriorated by 4 percent since 2011, on average. Oil exporters experienced a 21 percent plunge (Figure F6). These terms-of-trade shocks accounted for 1.5 percentage points of the investment growth slowdown in commodity exporters between 2011 and 2015, and 3.4 percentage points in energy exporters (World Bank 2017).

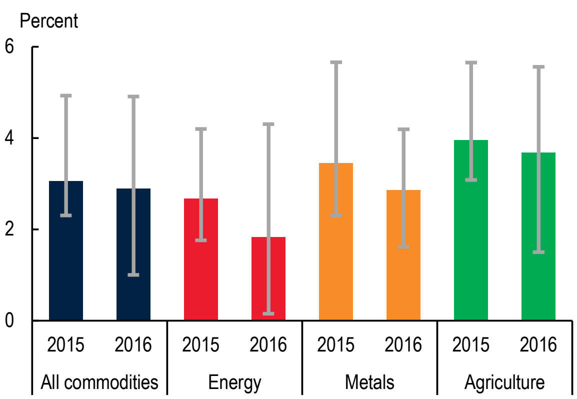
Rapid credit growth and debt overhang

On average, private credit in commodity exporters has increased by nearly 20 percentage points of GDP from 2000 to 2015. In about half of these economies credit to the non-financial private sector (as a ratio of GDP) grew more than 4 percentage points from 2015Q2 to 2016Q2. This is well above the long-term average yearly increase of 1 percentage point (World Bank 2016). Credit booms since 2010 have been unusually "investment-less" in commodity-exporting EMDEs (Figure F7).[1] Historically, when such investment-less credit booms unwind, output contracts more than when booms were accompanied by an investment surge (World Bank 2017).

Heightened uncertainty

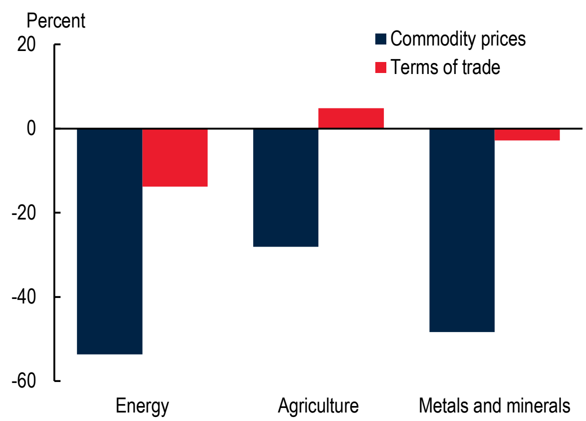
Political uncertainty has increased in many commodity-exporting EMDEs since the 2008-09 global financial crisis. This is a by product of geopolitical tensions in Eastern Europe, security challenges and conflicts in the Middle East, and acute domestic political tensions in several large commodity-exporting EMDEs. Deteriorated political stability in some commodity-export-

F5 Growth in commodity-exporting EMDEs



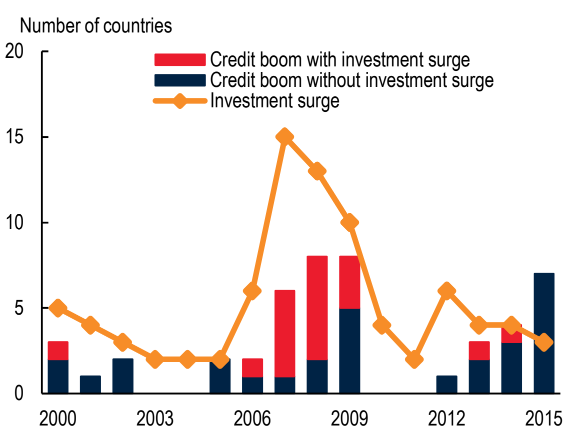
Source: International Monetary Fund.
Note: Growth is simple average of each country group.

F6 Price and TOT change: 2011Q1-2016Q3



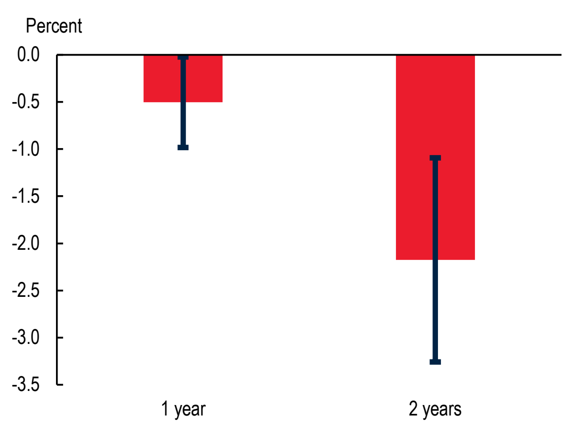
Source: World Bank.
Note: Change is in cumulative terms. TOT refers to Terms of Trade.

F7 Investment surge during credit booms



Source: World Bank.
Note: See endnote 1 for explanations.

F8 VIX impact on EMDE investment growth



Source: International Monetary Fund.
Notes: Refers to commodity-exporting EMDEs. For other notes and definitions see endnote 2.

ing EMDEs may have accounted for 0.7 percentage point of the total slowdown in investment growth in 2011-2015 (World Bank 2017). In addition, policy uncertainty in major advanced economies and in some major EMDEs has further weighed on investment growth in commodity-exporting EMDEs. For example, a 10 percent increase in the VIX volatility index can reduce investment growth in commodity-exporting EMDEs by 0.5 percentage point within a year (Figure F8).[2]

Which policies can help reignite investment growth?

Both external and domestic factors—low commodity prices, policy and political uncertainty, and weak growth prospects—are weighing on investment in EMDEs. In the near-term, some of these headwinds are expected to diminish, but only gradually. Investment growth is likely to remain subdued. However, many commodity-exporting EMDEs have large unmet investment needs. A number require investment in health, education, and infrastructure, and are poorly equipped to keep pace with rapid urbanization and changing demands on the work force. In addition, investment in the non-resource sector is needed to smooth a transition from natural resource-driven growth to more sustainable sources. Finally, a boost to investment, particularly private investment, would help revive slowing productivity growth. Robust policy action, even in countries with limited room to mobilize domestic resources, is needed to accelerate investment growth prospects.

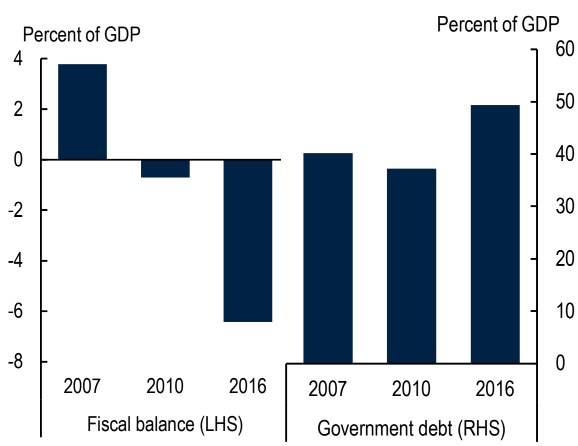
Although the specific policy needs depend on country circumstances, a full range of policies are needed to improve investment growth prospects. Counter-cyclical fiscal and monetary stimulus may not be effective given low commodity prices, diminished government revenues, and above-target inflation rates. On the other hand, structural policies could support investment by addressing the factors holding back private investment. These include measures to improve productivity and business climate, as well measures to reduce investor uncertainty.

Macroeconomic policies

Low commodity prices have weakened fiscal positions in commodity exporting EMDEs. Widening fiscal deficits and rapidly rising government debt levels leave only limited space for fiscal stimulus, despite the current low-interest rate environment (Figure F9). In about half of commodity-exporting EMDEs with sovereign wealth funds, assets cover less than one year of government expenditures (Figure F10). Absent fiscal space, shifting expenditures toward growth-enhancing investment or improving revenue collection, particularly in commodity exporters with low revenue-to-GDP ratios, can boost spending on public investment. Alternatively, authorities can gear policy efforts to developing private funding sources for investment. Many countries still lack adequate frameworks for effective public-private partnerships, which can improve the effectiveness of public investment (Engel, Fischer, and Galetovic 2008).

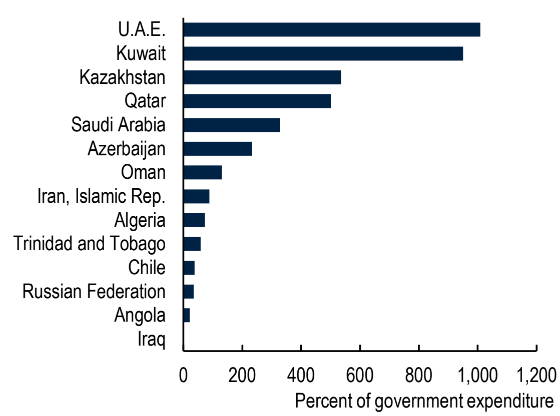
Like fiscal stimulus, monetary policy can boost growth and investment in a cyclical slowdown. However, with inflation already above target (about 3 percent on average), most commodity-exporting EMDEs have limited monetary policy space . Several commodity-exporting EMDEs have elevated external debt (Figure F11). Insofar as a large share of this debt is denominated in foreign currency, it can restrict policy makers' ability to allow currency depreciation in response to terms-of-trade shocks.

F9 Government debt and fiscal balance



Source: International Monetary Fund.
Notes: Balance and Debt data present unweighted averages across 89 and 86 commodity-exporting EMDEs, respectively.

F10 Sovereign wealth fund assets, 2016



Source: Sovereign Wealth Fund Institute, World Bank.
Note: Selected commodity-exporting EMDEs.

Structural policies

Structural reforms are particularly important for supporting investment in commodity-exporting EMDEs with limited room to deploy fiscal and monetary policies to generate stronger growth. Improving the business climate can both stimulate investment (domestic and foreign) and amplify the crowding-in effects of public investment. It can also offer indirect benefits through higher growth, less informality, and more dynamic job creation (Didier et al. 2015). For instance, lower startup costs are associated with higher profitability of incumbent firms, greater investment in information and communications technology, and more beneficial effects of FDI for domestic investment.

Reforms to reduce trade barriers can encourage FDI and aggregate investment. Governance and financial sector reforms can improve the allocation of resources, including capital, across firms and sectors. Labor and product market reforms that increase firm profitability can encourage investment. Stronger property rights can encourage corporate and real estate investment. Improved access to power supplies can increase firm investment and productivity.

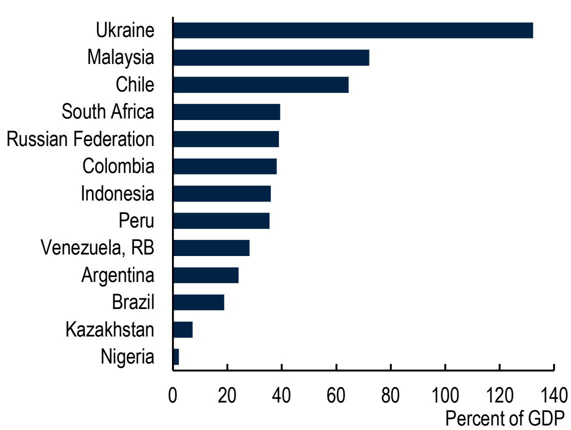
An important additional policy ingredient to strengthen prospects in commodity-exporting EMDEs is a robust fiscal framework for managing commodity price cycles that could turn commodity wealth into a steady flow of income and support long-term macroeconomic sustainability. In addition, promoting innovation and growth in non-extractive sectors, investing in research and development, and facilitating links between various industries can be effective policy options to boost investment growth. Three factors are critical for maximizing the benefits from structural policies: (i) strengthening fundamentals (stable growth and inflation, an open trade policy, transparency and good governance, and financial stability); (ii) enhancing infrastructure (roads, communication, and access to electricity and water); and (iii) human capital (World Bank 2015).

Progress in some structural areas has slowed in commodity-exporting EMDEs in recent years. During the six years preceding 2011, policymakers cut the cost of doing business considerably. Since then, however, while improvements have continued in some EMDEs, they have proceeded at a slower pace (Figure F12).[3] However, large reform spurts in commodity-exporting EMDEs have historically been associated with a higher investment growth of 5.7 percent.[4]

Conclusion

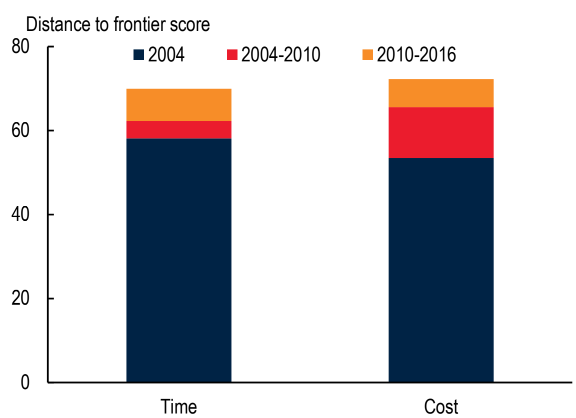
In line with the subdued economic activity, investment growth in commodity-exporting EMDEs has slowed sharply since 2010. Deteriorating terms of trade, rising private sector debt burdens, and growing uncertainty have contributed to this slowdown. Policies to remedy investment weakness in commodity-exporting EMDEs could include both cyclical and structural actions. However, commodity-exporting EMDEs have limited room to implement fiscal or monetary stimulus given eroded government revenues due to historically low commodity prices and above-target inflation rates. Structural reforms to enhance business environments, encourage economic diversification, and improve governance are therefore necessary to spur stronger investment public and private investment, attract foreign direct investment, and improve longer-term growth prospects.

F11 Total external debt, 2015



Source: World Development Indicators.
Note: Sample covers 13 commodity-exporting EMDEs.

F12 Distance to frontier: Ease of doing business



Source: World Bank.
Note: See endnote 3 for explanations.

Endnotes

1. A credit boom is defined as an episode during which the cyclical component of the nonfinancial private sector credit-to-GDP ratio is larger than 1.65 times its standard deviation in at least one year. Investment surges are defined as years when the cyclical component of the investment-to-GDP ratio is at least 1 times its standard deviation, while an investment slowdown is a year when the cyclical component of the investment-to-GDP ratio is below -1 times its standard deviation. Data covers thirty commodity exporters (Azerbaijan, Bahrain, Bolivia, Botswana, Colombia, Chile, Costa Rica, Côte d'Ivoire, Gabon, Ghana, Guatemala, Honduras, Jamaica, Kazakhstan, Kenya, Kuwait, Mongolia, Namibia, Nigeria, Oman, Panama, Paraguay, Peru, Qatar, República Bolivariana de Venezuela, Senegal, Sri Lanka, Ukraine, Uruguay, and Zambia).

2. This is estimated using a VAR model with data for 1992-2015. Investment growth in 83 commodity-exporting EMDEs, J.P. Morgan's Emerging Markets Bond Index (EMBI), MSCI's EMDE Index, and VIX are used as endogenous variables, and the U.S. 10-year bond yield and G-7 growth rate as exogenous variables.

3. Indicates proximity in score to country with the highest-ranking (best) scores for Ease of Doing Business across all time periods with available data. A rising distance to frontier score (DTF) indicates an improving business environment. Unweighted averages of commodity-exporting EMDEs. "Time" refers to the average DTF of the time to start a business, obtain construction permits, connect electricity, register property, pay taxes, and enforce contracts. "Cost" refers to the average DTF of the costs to starting a business, connect electricity, register property, and enforce contracts. Blue column denotes the DTF level in 2004. The red and orange columns denote the change in DTF over the respective periods. Each year denoted refers to June of previous year to June of current year.

4. The methodology follows Annex 3.2 of World Bank (2017) but applied to a sample of 83 commodity-exporting EMDEs instead of all EMDEs.

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