Promoting risk management approaches: Economic diversification

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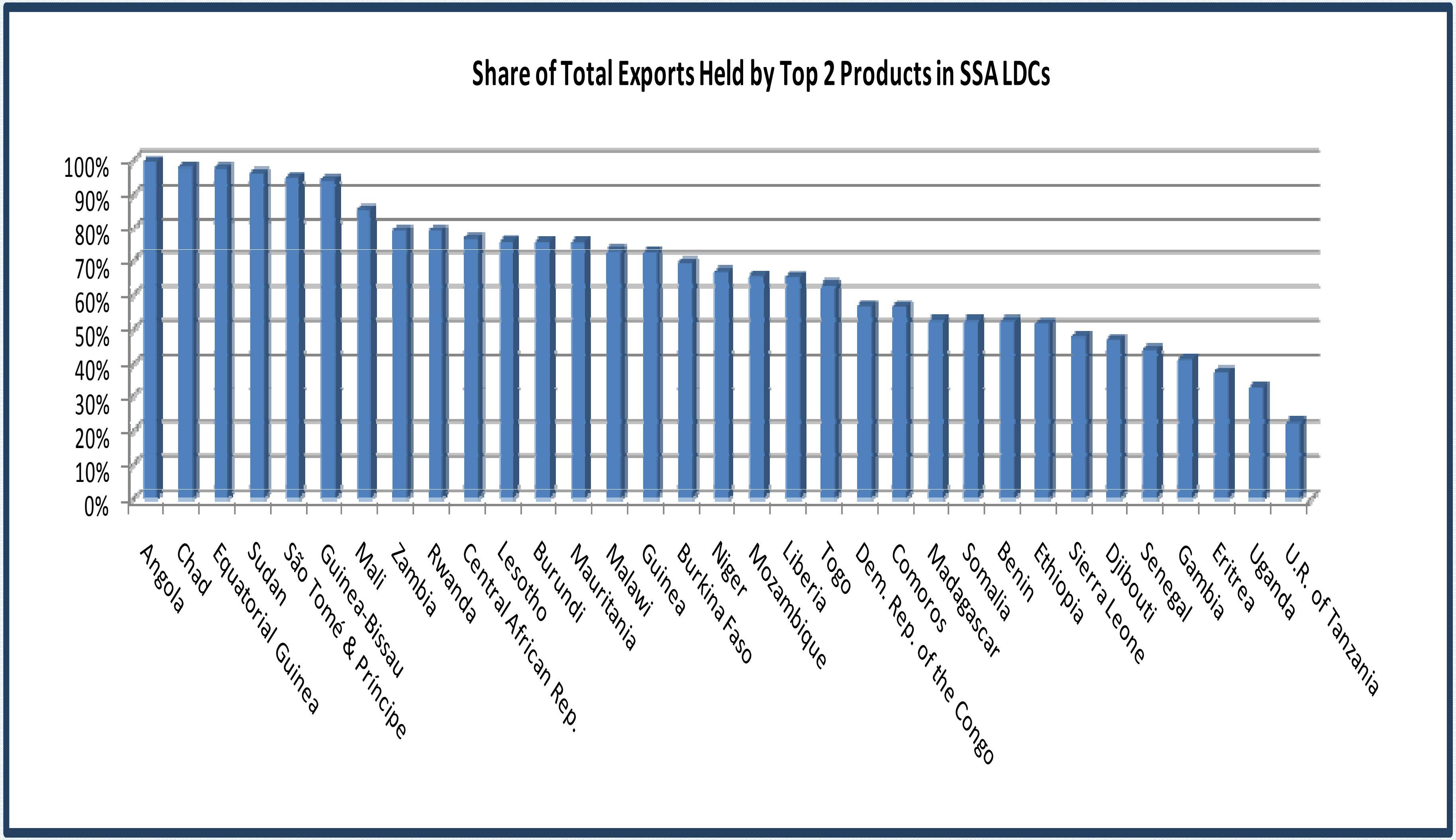
What is economic diversification?

- A wide range of economic production within the economy
- Usually concerned with diversifying away from narrow range of commodity production
- Typically measured by: UNCTAD’s Economic Vulnerability Index (EVI)

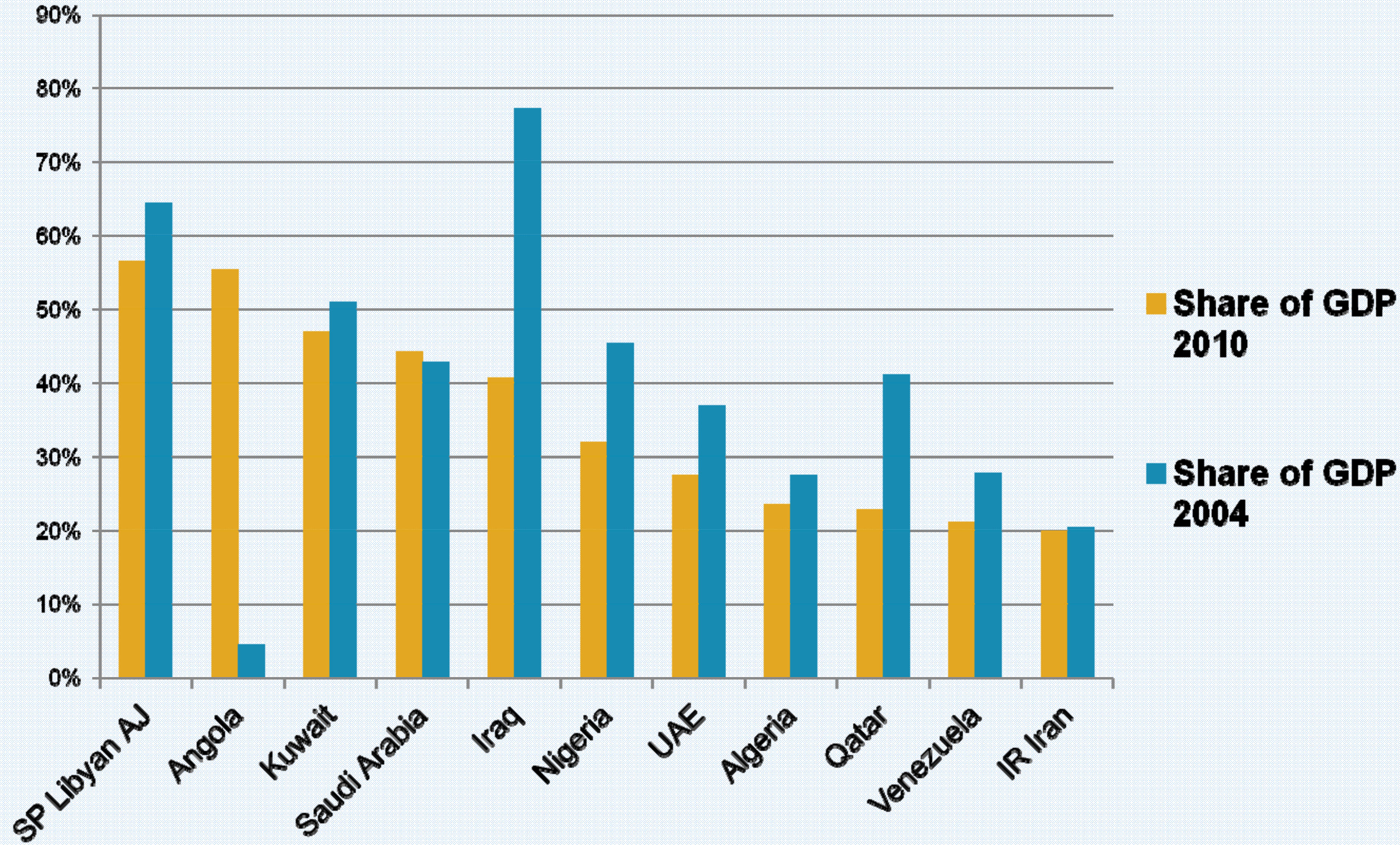
Why economic diversification?

- Identified as an antidote to the adverse impacts of response measures, by two SB workshops (Tehran 2003; Bonn 2006).
- In the context of 1/CP.10, most concerned with concentration of exports in sectors likely to be affected by response measures: fossil fuels, and GHG-intensive goods & services
- Overdependence on these sectors (and a high export to GDP ratio) amplifies the economy's vulnerability to adverse impacts.



Source: Cosbey (2010)

OPEC Crude Oil Exports



Source: OPEC Annual Statistical Bulletin 2011

Why economic diversification? (cont'd)

- Shelters countries from other negative effects as well:
  - "Dutch disease": crowds out other tradable sectors
  - Cyclical swings in commodity prices bring instability
  - Pressures of rent-seeking are corrosive for good governance

Broadening the focus

- Workshops identified economic diversification as one part of a broader preoccupation: economic development, which in turn is part of sustainable development.
- They emphasized that economic diversification needs to be embedded in broader national efforts to achieve sustainable development -- successful efforts must mesh with, derive from, nationally enunciated development priorities.

The theory

- Recent prevailing wisdom: governments can’t do industrial policy. Best to stick to general enabling conditions, e.g.:
  - macroeconomic stability
  - labour market flexibility
  - education policies
  - general infrastructure
  - low business taxes

The theory (cont'd)

"There is no miracle recipe to achieve diversification overnight. Fostering diversification will be a long drawn out process, and should hence be seen as a long-term goal. There is no shortage of examples of failed diversification policies, and economists know fairly well on the basis of international experience what does not work. ... Unfortunately, there is less agreement among economists about what does work, as policies that work well in one place often fail dramatically elsewhere. Indeed, failures have been so common (and sometimes so spectacular) that, in recent years, economists have often preferred not to give any advice at all with respect to diversification policies."

Source: Rudiger (2006:12)

The theory (cont'd)

- New thinking, based in part on success of Asian emerging economies (China, Korea, Taiwan, India): strategic industrial policy can work.
- Needs to be focused on exports, so "infant industries" eventually must grow up.
- But no cookie-cutter solutions – highly country specific.

The Practice: Success stories

- **Dubai, UAE:** Oil & gas <6% of GDP. Major financial services, tourism, transport industries. Policies included:
  - Investment of oil revenues in state-of-art infrastructure (transportation, telecommunications,)
  - Creation of multiple "free zones" with liberal requirements on foreign ownership/capital repatriation, low or zero taxes: investment, Internet, media, outsourcing zones
  - (heavily hit by financial crisis, though, exposing weaknesses)

The Practice: Success stories

- **Mauritius:** Between 1976-2010, primary sector shrank from 23% to 6% of economy. Services (tourism, financial) at 70% of economy. Sugar from 20% to 4%
- Policies:
  - EPZs, human capital development, social welfare system, trade openness, flexible exchange rate, prudent fiscal policies, public-private sector cooperation, ...

The Practice: Success stories

- **Brunei:** *not* yet successful. Oil and gas dominate the economy. Four decades of serious efforts, plagued by:
  - Overvalued exchange rate ("Dutch disease")
  - Bloated public service
  - Corruption
  - Nationalism with respect to investment
  - Thin capital markets, conservative lending
- New efforts focused on oil and gas upstream, ICTs, tourism, infrastructure.

Principles

- Openness to trade, investment
- Export focus
- Target sectors within “reach” of existing capacity
- Infrastructure expenditure
- Human resource development
- Flexibility, trial and error

Institutional issues for UNFCCC

- Can the UNFCCC “do” diversification?
- Arguably not – no expertise, mandate
- But there is a mandate to have it done.
- Partner with those that are expert in this area – decades of experience:
  - MDBs (e.g., World Bank)
  - Development agencies (e.g., GTZ)

Closing thought

- Economic diversification is a decades-long effort, fraught with complex challenges.
- Daunting challenges specific to oil exporters – e.g., “Dutch disease”
- But it needs to be done, and it can be done.

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