DIIS POLICY BRIEF

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The lure of extractive natural resource development

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Natural resource-driven development in Africa has emerged as a hot topic. The hope is that extractive industries will generate foreign revenues, create jobs and boost economic growth – but how can the possibilities best be exploited for industrial development purposes?

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This brief explores the opportunities offered by the new boom in natural resource extraction, and focuses on how foreign direct investment (FDI) by extractive multinational corporations (MNCs) can be harnessed for industrial development purposes. The brief argues that industrial policies are needed in order to unleash the development potentials provided by FDI in extractives.

1. INDUSTRIAL POLICIES ARE NEEDED TO UNLEASH DEVELOPMENT POTENTIALS

Industrial policies broadly refer to any targeted government support for specific productive sectors, industries and even firms. By promoting linkages between extractive MNCs and local firms, industrial policies may help support the process of economic transformation needed if Africa's economies are to have broad-based job-creating growth and poverty reduction. But so far, African countries have generally not been able to carry out efficient industrial policy. Industrial policy is about active government involvement in promoting production in agriculture and manufacturing, as well as providing the public goods necessary for technological advancement. Basic public

POLICY RECOMMENDATIONS

Donors

- should engage more actively in the extractive sector where they can play a pivotal role in securing positive development outcomes.
- should tie their numerous value chain development programs specifically to promote value chains that link up to the extractives industries.
- should target the larger local firms that (potentially) have the best abilities to establish links with foreign extractive industry firms and create jobs.
- should assist in promoting inter-firm transactions by strengthening the specific institutions set up to promote and manage such relationships.
- should support industrial policies which may serve to create the conditions for upgrading the local economy technologically or infrastructurally, as well as supporting skill training and technical education.
- should take into consideration how their programs affect the balance between local political and economic elites.

goods are education and infrastructure, such as road and power supply. Industrial policy is also about targeting specific sectors of the economy that appear promising. For example, the government may provide subsidized loans for investors in a certain industry, or they may invest in research and development in a certain sector.

Donors can play an important and constructive role in supporting industrial policy in general and developing linkages in the extractives sector specifically. The arguments for donor support are based on three propositions:

1. the potentials for linkage formation related to extractive industries are significant, as is the likely impact in terms of economic transformation and sustained poverty alleviation;
2. the extractives sector is among the fastest growing in many African countries, which also makes it commercially interesting for some donors; and
3. the start-up and development of industries linked to extractive industries is slow, takes time and requires funds as well as the technical and institutional knowhow that some donors may be able to provide.

2. BEYOND THE RESOURCE CURSE

Where natural resource based development in Africa has often been depicted as a resource curse – the tendency of countries with high levels of natural resources to exhibit worse economic and political outcomes – recent accounts have tended to emphasize that abundant natural resource endowments may lead to a broad based and poverty reducing economic development process.

Instead this brief focuses on the economic and industrial development potential of extractive FDI, emphasizing the conditions under which extractive FDI will produce developmental outcomes. The report that this brief is based on (Extractive Natural Resource Development: Governance, Linkages and Aid) in particular emphasizes the role of governments. Governments must play an essential role with regard to three types of engagement: **The first** more general role for governments is related to creating the foundation(s) on which natural resource development can take place by improving education, making sure infrastructure, research and development and access to markets have been enabled, as well as making sure investment and ownership policies are developed. **The second** role is related to securing funding for these activities by optimizing the revenues from natural resources by creating and enforcing tax and incentives regimes. Finally, **the third** role is to enable economic linkages between the natural resource sector and the wider economy to spur inclusive growth.

Industrial policy is needed to improve technological capabilities among firms that may become suppliers for the

LINKAGES

Linkages are inter-firm transactions that go beyond one-off transactions and involve longer term collaborations between the involved parties. Linkages can be backward, forward or horizontal. Hence linkages may focus on longer term exchanges of goods and services as either inputs (backward linkages) or outputs (forward linkages). Backward linkages include subcontracting, supplier contracts, input service collaborations, etc. Forward linkages include distributor and franchise agreements or contracts with agents and after-sales service providers. Horizontal linkages are collaborations between firms in the same industry based on licensing, technology alliances, joint buying arrangements and even joint ownership (joint ventures). Linkages have a 'quantitative' as well as a 'qualitative' dimension also called the 'breadth' and 'depth' of linkages. The breadth of linkages concerns the number and scope of linkages, the depth of linkages the extent of local value added.

In discussing the development effects of FDI, it is useful to make a distinction between 'direct' effects (effects related to the isolated activities of the MNC affiliate), 'indirect' effects (effects on related firms such as suppliers and service providers) and spill-over effects (effects on un-related firms).

LINKAGE DEVELOPMENT

Linkage development is concerned with achieving the most optimal and best-fit alignment between the commodity producers and their suppliers and the processors of their output. It is concerned with increasing the scale, range and depth of domestic capabilities. Central to such endeavours is the need for putting into place visions, policies, strategies and implementation plans – in short; industrial policies through which governments enable the creation of linkages and promote systemic competitiveness within extractive industries.

To promote linkages, governments and donors employ a range of measures: local content and ownership requirements, local processing standards and aims for hiring of staff, as well as compulsory corporate social responsibility (CSR) programs, mandatory local content reporting requirements and supplier development programs.

THE TEN LARGEST GREENELD PROJECTS IN LEAST DEVELOPED COUNTRIES, 2011

Host economy	Industry	Investing company	Home economy	Estimated investment ($ million)	Estimated jobs created
Mozambique	Fossil fuel electric power	Jindal Steel & Power	India	3000	368
Uganda	Oil and gas extraction	Tullow Oil	United Kingdom	2000	783
Mozambique	Natural, liquefied and compressed gas	Eni SpA	Italy	1819	161
Mozambique	Natural, liquefied and compressed gas	Sasol Petroleum International	South Africa	1819	161
Equatorial Guinea	Oil and gas extraction	Noble Energi	United States	1600	626
Democratic Republic of the Congo	Copper, nickel, lead and zinc mining	Freeport McMoRan	United States	850	1459
United Republic of Tanzania	Fossil fuel electric power	Castletown Enterprises	United Kingdom	799	118
Zambia	Copper, nickel, lead and zinc mining	Non-Ferrous China Africa (NFCA)	China	700	1201
Democratic Republic of the Congo	Iron ore mining	Sundance Resources	Australia	620	1063
Lao People's Democratic Republic	Biomass power	Thai Biogas Energy	Thailand	558	700

Source: UNCTAD (2012, Table 11.4)

multinationals that invest in natural resources. But industrial policy is also needed to promote economic transformation in general, to help upgrade and invest in agribusiness and industries that can then employ a larger share of the labor force. It is therefore important to note that industrial policy is important both in terms of creating linkages directly related to exploitation of natural resources, as well as in terms of promoting industries by using oil, gas and mineral revenues to promote economic transformation in sectors of the economy outside the specific natural resource.

Without pro-active industrial policies, resource rents and revenues may not be used to generate growth and employment in agriculture, industry and services more broadly. The good thing is that many African countries have recently prioritized the exploitation of extractive natural resources in their development strategies. A new development agenda is therefore slowly emerging in many African countries, which will have many and important implications for donor agencies. The question is if they are ready to engage constructively in this new development agenda or whether they choose to stick to the traditional poverty agenda.

3. SCOPE AND OPPORTUNITIES

The volume and scale of investments in Africa´s natural resources over the last decade have been staggering. During the 2000s three-quarters of all FDI went to the resource-rich countries in Africa according to African Development Bank (2013). Moreover, as pointed out by African Economic Overlook (2013), 60% of all FDI being invested in Africa is in natural resource extraction.

Mega-projects are shooting up in extractive industries. Oil and natural gas reserves in Uganda, Kenya, Mozambique and Tanzania, for example, are pulling FDI to Eastern Africa. Here, six out of the ten largest investments in 2011 are greenfield investments in extractive industries, as the table shows. It is also notable that south–south investments are becoming as important as north–south investments on the African continent.

It is expensive and requires technologically advanced equipment and specialized skills to extract most natural resources. Skills that are simply not available in most African countries. Moreover, it is important to be integrated into global value chains in order to benefit from extractive commodities. Furthermore, due to the capital intensity of most extractive operations, developing countries will typically need foreign investors in order to exploit their natural resource endowments. MNCs therefore dominate extractives in sub-Saharan Africa, where foreign companies account for 100 percent of large scale production in several mineral-rich countries.

Even if the heavy presence of multinational companies in the extractive sector may threaten to create a new type of dependence, the extractive resource economy is still considered attractive and worth pursuing. The key reason is that changes in the world economy provide new opportunities for Africa. With rising costs of production in China and the continued growing domestic demand in East Asia for resources, the scope for industrialization based on natural resources in Africa is growing. This optimism is widely shared by many international organizations ranging from the African Union and the African Development Bank to the World Bank and, with some reservations, also the United Nations Conference on Trade and Development.

As more and more countries develop the technological capabilities necessary for industrialization, competition in global manufacturing has increased, and prices of manufactured goods have declined. But natural resource prices have not declined with the same pace. These changes in the global economy have important implications for less developed countries trying to use extractive natural resources for poverty alleviation, economic transformation and development. It is no longer helpful to think solely in terms of pursuing manufacturing and industrialization writ large, but rather to consider how to position national economies, sectors and firms in regional and global markets in order to create wealth and employment.

4. INDUSTRIAL POLICY, POLITICS OF ELITE SURVIVAL, AND FUTURE PROSPECTS

The realization of the potential offered by the natural resource endowment in many African countries has, nonetheless, been rather elusive so far even though investments in extractive industries and economic growth have been high. The danger of a "resource curse" is no doubt real.

Thus, experience from many countries show that incomes from extractives do not automatically have job-creating effects. Indeed, the impact on employment is typically low. Greenfield FDI into mining, for example, created a mere 400,000 jobs between 2003 and 2012 on the African continent as a whole. Moreover, the rising value of natural resource exports can lead to an appreciation of the real exchange rate ("Dutch Disease"), which generally makes other (non-natural resource) commodity exports less competitive, and therefore slows down economic transformation.

In addition, extractive incomes can be captured by political elites and used to further strengthen their hold on power. The key mechanism linking authoritarian rule and resource dependence is the ruling elite's discretion over the distribution of natural resource rents. Control of such rents reduces elite accountability and fuels corruption and this can derail both democratic transition and democratic consolidation. In times when winning elections are important, ruling political elites will therefore focus on what helps them stay in power, such as providing patronage to politically important groups, or prioritizing policies that will benefit many voters in the short run. Consequently, investing in long term industrial policies that have uncertain effects on the future economy is not the top priority of ruling elites. These dynamics explain why industrial policy has been and will continue to be difficult in many African countries.

This is a problem because proactive industrial policies are essential if African economies are to benefit from foreign investments in natural resources through employment creation and poverty reduction broadly. The challenge, of course, is that such industrial policies require institutions that are able to implement them. And the establishment of such institutions requires ruling elites who are able to protect important resources from rent seeking and corruption.

5. A GOOD FIT RATHER THAN BEST PRACTICES

We argue that policy recommendations should reflect the 'good fit' with local contexts, institutions and politics, and not only the 'best practices' on which donors typically base their advice. There is a tendency to discuss linkage formation and industrial policy purely in terms of economic efficiency, thus neglecting the political context in which such policies are implemented.

FURTHER READING

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