PRINCETON Sovereign Finance Lab

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How Do Governments Respond to Persistently High Commodity Prices?

Christian Baehr (PhD Candidate, Princeton University and Graduate Fellow, PSFL)

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Global commodity prices reached historic levels in 2022 and 2023, the result of both post-pandemic recovery of demand as well as conflict- and climate-related shocks to supply. While some commodity prices have retreated from their most extreme highs, the longer-term outlook is that higher prices are here to stay.

Some economies are particularly sensitive to commodity price increases. For these countries, international commodity volatility takes domestic economic performance out of the control of national leaders (Campello and Zucco 2020), for better or worse. Which countries stand to win and which stand to lose from these price increases? What are the consequences of commodity prices for domestic politics? This brief examines these questions.

Commodity Exporters: More Money, More Problems?

High commodity prices produce a revenue windfall for commodity-producing countries, through increased taxation of income, increased revenues for state-owned enterprises or both. Under what conditions do these windfalls improve economic growth and well-being?

The literature on the “natural resource curse” suggests that resource-related windfalls may not improve outcomes (Ross 2015; van der Ploeg 2011; Venables 2016). Countries with abundant natural resources tend to perform at similar levels economically, and *worse* politically, than those without.

Resource windfalls may allow governments to avoid increasing taxes to generate revenue. To the extent that tax increases lead citizens to demand greater government accountability, increased government fiscal capacity without concomitant tax increases can blunt such demands (Levi 1988; Bates and Lien 1985; Martin 2023). Resource windfalls can then provide governments with more autonomy in fiscal policymaking; office-motivated politicians may use commodity income for more self-serving, rather than socially optimal, purposes. Thes include political patronage and bribery, as well as policies that disproportionately benefit constituencies important to leaders’ survival in office.

Commodity price shocks also make it more difficult for voters to assess the performance of incumbent leaders. A large body of evidence in political science suggests that voters assess politicians *retrospectively* (Kramer 1971). But during commodity price bust or boom periods, it becomes more difficult to assess whether leaders are to blame for economic performance (Campello and Zucco 2020). A surge in export revenues may be the result of high global prices, rather than improvements in domestic productivity, for instance. And a collapse in domestic employment could be due to declining world prices for exports, rather than economic mismanagement. Distinguishing low- from high-quality politicians is generally more difficult for voters when a country's economy is more exposed (for better or worse) to external shocks; this dynamic is intensified during more pronounced commodity price swings.

The news for citizens isn't all bad, however: in commodity exporting countries, new government revenues from high commodity prices *could be* used to advance social welfare. And many commodity-producing countries also have stark inequalities and high poverty rates. Reduced dependence on international financial markets during high commodity prices may mean fewer external restrictions on implementing redistributive social policies (Campello 2015), especially for left-wing governments. Indeed, during the commodity price boom of 2000 to 2014, left-leaning governments in Bolivia (under President Evo Morales), Peru (under President Ollanta Humala), and Brazil (under President Luiz Inácio Lula da Silva) implemented large-scale social welfare and cash transfer programs.

New demand for less-skilled labor during commodity price booms also can reduce poverty and inequality, as has sometimes occurred in Latin American countries. To maintain economic momentum once a boom ends and to protect themselves from busts, however, governments need to diversify their economies.

Can we expect governments to invest income windfalls from high commodity prices into economic diversification? Kurtz and Brooks (2011) find that resource-dependent countries with high pre-existing levels of human capital and international integration can break free of the resource curse by using resource revenues to foster new competitive industries. Development of new industries and national comparative advantages, however, often requires continued investment beyond the horizon of a single commodity price cycle (Lashitew et al. 2021), and perhaps beyond the time horizon of the incumbent government.

Another potential benefit of higher prices for commodity exporters is reduced dependence on private financial markets. Campello (2015) finds that during periods of abundant global liquidity and high commodity prices, commodity-producing countries can generate foreign exchange through exports. Their need for international borrowing declines, perhaps at the same time when market participants would deem their ability to repay debt as highest.

Additionally, private investment inflows are typically at their highest during global commodity price booms (Reinhart et al. 2016). Hence, commodity exporters may temporarily face fewer market-based pressures for macroeconomic reform or other market-friendly policy measures during price booms (Goes and Kaplan 2024).

Commodity Importers: Biting The Hand That Feeds?

By contrast, high commodity prices mean significant economic and political pressures for countries that rely heavily on imported commodities. The increased costs of inputs slow production and lower tax revenues. Higher food and fuel costs also can mean increased economic insecurity for their publics.

These pressures are especially pronounced for governments that heavily subsidize consumption of imported food or fuel. Figure 1 displays spending on gasoline subsidies across countries in 2022 as a percent of government expenditures. The political factors that lead countries to provide subsidies in the first place are unclear; explanations often rest on country-specific idiosyncrasies (Mahdavi et al. 2022).

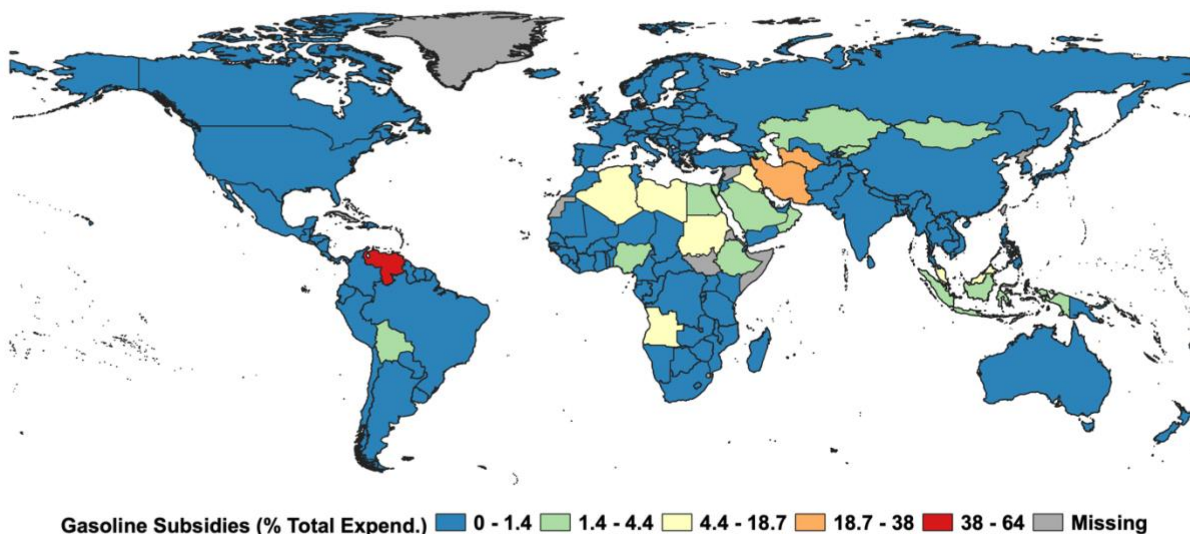

Figure 1: Gasoline subsidies as a percent of government expenditures in 2022. Data from the IMF and the World Bank.

As governments face growing fiscal pressures from high commodity prices, they may need to reduce or remove these commodity subsidies. Indeed, Angola cut fuel subsidies in mid-

2023, a move that is consistent with advice from the International Monetary Fund. Morocco, seeking to tap international bond markets later this year, also recently cut fuel subsidies.

The domestic politics of winding down existing subsidies, however, are extremely perilous. The experience of Egypt demonstrates how difficult it can be for governments to wean off subsidies. Egypt has a history, dating back to the 1920s, of using food subsidies. An effort by the government to reduce subsidies for some commodities in 1977, under pressure from the IMF, was met with widespread riots. After receiving an eight billion dollar financial package from the IMF in April 2024 to stave off a possible default, the government announced an increase in the price of pita bread that took effect on June 1. The move has already contributed to a reshuffling of Prime Minister Mostafa Madbouly's cabinet. The full political consequences from the bread price increase are still unfolding. Harsh penalties implemented by President Abdel Fattah El-Sisi on collective action, however, may discourage rioting and protest.

Nigeria's current political situation also provides insight into the perils of removing subsidies. On his first day office in 2023, Nigerian president Bola Tinubu removed all national food and gas subsidies. The action was part of a broader effort to achieve fiscal sustainability and catalyze foreign investment into Nigeria; the country's debt servicing costs had reached nearly one hundred percent of government revenues.

This removal of food subsidies exacerbated already high food insecurity. Widespread protests resulted, culminating in August 2023 in protestors' forced entry into the Nigerian National Assembly property. The Tinubu government has since reinstated both fuel and food subsidies. Despite being an oil producer poised to benefit from persistently high fossil fuel prices, Nigeria will spend nearly half of its 2024 oil export income on the reinstated fuel subsidies. Domestic subsidies diminish the benefits that commodity exporters can reap from the favorable combination of abundant commodity endowments and high international prices.

Governments in democracies worry about protests because they signal an increased possibility of defeat in the next election.[1] For leaders of less democratic or fully autocratic countries, the calculation is somewhat different: they may worry about irregular removal from office, prompted by urban protests, strikes and riots (Beissinger 2022). Along these lines, Cameron Ballard-Rosa (2020) finds that authoritarian leaders have strong incentives to maintain existing food subsidies that support primarily urban populations. Authoritarian leaders will thus be more likely to default on existing debts or to miss debt servicing payments rather than to slash subsidies for urban populations.

[1] PSFL Policy Brief 24-1 details the implications of upcoming elections for government financing.

Indeed, authoritarian, commodity-importing governments may be in precarious positions. Keeping subsidies in place becomes more expensive as global prices rise, and many such countries also have significant debt servicing burdens. At the same time, private markets tend to be less willing to extend credit to such governments (an "autocratic disadvantage") when global liquidity tightens (Ballard-Rosa et al. 2021). This might push such governments to borrow from international financial institutions such as the IMF. Yet organizations such as the IMF are *exactly the ones most likely to demand subsidy removal* as part of a conditional lending package. In generating terms and conditions for new loan packages to governments, international lenders must keep in mind the domestic political pressure points that are most sensitive. Political leaders certainly won't ignore those.