CHAPTER IV

THE IMPACTS ON DEVELOPING COUNTRIES

Basically countries in this category derive from those in the Third World. Most of them are members of G77, resided in Asia, Africa, and Latin America. These developing countries are measured by the rate of their high dependency on energy and their economies rely largely upon the use of imported crude oil. It is evident that those countries have been harshly hit and suffered most, compared to countries in other classifications.

This chapter will explore the general background of rising oil price impacts on the development and economy of those countries from developing world since 1970s until the present situation of oil prices. Moreover, given impacts on developing economy will be exemplify by the case of China, the rising power and fast growing economy with greatest rate of oil consumption as well as African countries which seem to be most severely effected by due to their weak economy and policy.

A. Background of Oil Impacts on Economy in Developing Countries

A consumption rate, though, are not higher than that in the first world, they are affected severely from every penny that increases in the price of oil. It is because their economies are not well protected, as having none effective regulation imposed by the governments. Then, rapid industrialization requires massive amount of energy,

whenever the price rises, their developments and economies are likely be in stagnation.

By comparing with those from the developed world, every $ 10 increase in the price would reduce GDP by 0.8%, 1.6% in poor, indebted countries and 3% in some African countries, in comparison to only 0.4% decrease in OECD members, because they use twice as much oil to produce a unit of output as more developed countries.

More visible impacts upon development, would force the countries to discontinue ongoing processes which include 1) modernization, 2) urbanization and 3) industrialization. Not only economic, but social impacts are also felt among the developing. Nevertheless, amidst economic and development collapse, familiarity to economic hardship would lead to economic adaptability, referring to energy efficiency, and energy saving. From my point of view, there would be a gradual change in their economic and social lives, as time goes by. Society would thus be converted into an old style, self-reliant economy, regaining economic independence. After all, economic adjustment involved simplicity of life style, in association with self sufficiency philosophy, would slowly wipe out materialism and consumerism, making change in social life of citizen, as a whole.

B. The Impacts of Oil Price Increase during 2004- 2006 on Given Developing Economies

I. China

The rise in oil prices affects the Chinese economy in three ways. First, higher oil prices translate to higher production costs for Chinese manufacturing firms. So while prices rise, output falls. At the same time, because the industrialized countries that are the major importers of goods made in China are similarly affected by a rise in oil prices, China's exports drop as a result of the deceleration of the global economy and production decreases even further.

Furthermore, a rise in oil prices signifies deterioration in China's terms of trade[16], and the purchasing power of China's national income declines accordingly. When we consider that China's net oil imports come to $30 billion annually, a 10% rise in oil prices means that China's import costs rise by an additional $3 billion. This is equivalent to an income transfer from China to oil exporters, and at some point this becomes a public burden in the form of lower corporate earnings and higher consumer prices.

The rise in oil prices is largely a "supply-side shock" that requires countermeasures on the supply side rather than macroeconomic measures that

[16] Chi Hung Kwan, "How to Overcome the Oil Crisis - Energy Conservation Efforts Are the Key, October 2004, www.rieti.go.jp/en/china/04100101.html.

stimulate demand. Among such measures, as the experience of many industrialized countries including Japan has shown, energy conservation measures are the most effective. By boosting energy efficiency, production costs will fall and output will rise. Of course, such measures will require investment, but the more expensive oil becomes, the more profitable investments in energy-saving measures will be. In addition, compared to Japan during the first oil shock, China should be able to obtain more advanced energy-saving technology at a lower cost from international markets

Up to now, China has viewed environmental protection and economic development as two objectives that cannot be met simultaneously; like many developing countries, the government has chosen to "place priority on economic development even at the cost of the environment." As in Japan's case, there are "success stories" where it was possible to tackle environmental issues after completing the industrialization process, and China has so far failed to adopt sufficient environmental protection policies. However, recognition is spreading that large-scale energy consumption not only causes environmental damage such as air pollution and resource depletion, but also adversely affects the international competitiveness of industry and hampers economic growth through higher costs. In fact, post-oil shock Japan managed to simultaneously clean up its environment and boost its international competitiveness through energy conservation efforts. This is the lesson China should learn from Japan's experience.

In the face of the oil shock, Japan's 1974 White Paper on the Environment states the following regarding the situation Japan faced and the measures the government should take:

“Through this "oil shock," our country, which is totally dependent on other countries for its oil supply, experienced the need to make efforts to use energy efficiently through all possible means. At the same time, however, the mass consumption of energy has been a major factor behind the environmental pollution we have seen to date. In this sense, environmental issues and energy issues may be said to be problems that must be solved simultaneously as "two sides of the same coin." From this viewpoint, the direction our country should take is to achieve a pollution-free and energy-saving economic structure, and to have the idea of efficient energy use, based on the premise of environmental protection, permeate all areas of our economy so as to establish a society that enjoys high economic growth with little energy consumption."[17]

In addition, China’s dependency on oil requires economic immunity that could be arisen from the rise of oil price. Over-booming economy of China must be controlled and managed by the Chinese Government so that in the future when the supply is scarce, the Chinese economy will not be paralyzed by the decline of energy supply.

II. African countries

[17] See footnote 16

The impacts of higher oil prices on countries in this category differs countries to countries since African continent can be divided into oil importing and exporting countries.

II.I. Impacts on African oil Importing Countries

The high price of oil impacts directly on firms, consumers and the government. First, it increases the domestic price of petroleum products, raises the cost of many intermediate inputs, and as a result leads to higher production costs. Consequently firms may reduce their labor demand, investment and output. Second, as the short-run demand for oil is highly inelastic, consumers are forced to reduce their consumption of other goods and services to pay for higher energy bills. Third, net oil-importing countries face balance of payment constraints as they must secure additional resources to pay for the higher oil import bill. Governments also face tighter budget constraints which can affect their capacity to finance social programs.

Overall, we can expect the impact to be quite significant on their balance of payments as oil accounts for 10 to 15 per cent of the median African country imports[18]. In the absence of sufficient external reserves, or external borrowing, reductions in domestic consumption and investment will undermine even more their economic performance. Countries which resort to continued external borrowing to finance their budget shortfall will face higher debt servicing, and possibly debt sustainability problems, in the future.

[18] African Development Bank Group, "High Oil Prices and The African Economy,"Burkina Faso,2006, http://www.afdb.org.

Poverty is another important aspect of higher oil price in African oil importing country. Lower employment prospects and the higher inflation rate will lower the purchasing power of the poor who have fewer (if any) instruments to hedge against the oil price increase. The biggest impact will be through higher price of kerosene which is used for cooking and lighting. The poor will also be affected by higher transportation costs. Clearly, higher petroleum costs will increase commuting costs and, especially in the case of agricultural economies, the cost of getting the crops to the markets. However, governments should resist the temptation to provide subsidies to offset the high price of energy. Subsidies constitute a serious drain on public finances, especially if the high price of oil persists. They will have to be financed through higher taxes, or external borrowing which will generate a higher debt burden. Moreover, although kerosene is considered an inferior good, it is not clear that subsidizing it is the best means to protect the poor because it is difficult to prevent non-poor from consuming kerosene. Discretionary fiscal response should be limited since it may be difficult to remove in the future.

II.II Impacts on African oil Exporting Countries

The 5 top oil-producing countries (Nigeria, Algeria, Libya, Angola and Egypt) account for more than 80 per cent of the continent's production[19]. Impacts of rising oil price may differ slightly from those African countries importing oil.

[19] See footnote 18

First, the oil wealth, if properly managed, could help oil-producing countries grow quickly. However, governments should be aware of the distortions that an oil boom can create through inflows of sizable foreign exchange earnings. The real exchange rate can appreciate through growing inflation and nominal currency revaluation. The non-traded sector could expand and non-oil traded goods lose competitiveness and decline. This is called the classical Dutch-disease pattern. Consequently, it is advisable that the monetary authorities adopt a non-inflationary policy to avoid hyperinflation and to maintain monetary credibility.

Concerning the issue of poverty and income distribution, oil-rich African countries do not have lower poverty rates than the rest of Africa. Now, the challenge is to translate those higher growth numbers, and value of oil stocks, into lower poverty rates. This requires that oil-producing countries adopt sound institutions and appropriate macroeconomic policies. They need to invest in projects which yield the highest social rates of returns, such as education and infrastructure, and not in prestige enhancing projects. Moreover, care must be taken that the extra oil revenue does not accrue only to some segments of the population while the living standard of the others remains unchanged or worsens.

The natural oil reserves in some African countries could also be taken as an opportunity to reinforce regional cooperation, regional infrastructure projects, and regional energy integration. In that regards, the NEPAD energy projects are worth being highlighted. For instance, the DRC-Angola-Namibia Interconnection could link the existing Inga to South Africa through the Angolan and Namibian grids. A similar

project is the West Africa Power Pool to integrate power systems across eight countries.