

How to Cope with Dutch Disease in Least Developed Countries

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Introduction

Africa is going to discover and extract more and more of its natural resources. Many expect that this will be a big blessing for Sub-Saharan Africa and other Least Developed Countries (LDCs) and will lift many out of poverty. History shows, however, that in terms of economic growth, oil-rich countries performed worse than countries with no relevant natural resources (Sachs and Warner 2001 for the period 1970-89) as they had suffered from Dutch disease, which had led to currency appreciation. Therefore lessons should be learnt from resource-rich countries, both positive and negative.



Oil-boom 1999-2008 – what results?

The study 2 enquires how some 20 energy-rich countries performed during the last oil price boom between 1999 and 2008, when oil prices mushroomed by more than 900 percent. The sample included only two LDCs, namely Nigeria and Angola. The reason why there are only few LDCs among the group of oil/gas exporting countries is that energy export revenues tend to lift the country out of the LDC status. For comparison, Norway and the group of OECD countries were included. Fuel exports as a percentage of merchandise exports amount to more than 70 percent in the energy-rich countries (average), with much lower shares in Indonesia and Mexico. The natural resource rents of these countries average around 48 percent of GDP at the peak of the oil boom, with much lower shares again for Indonesia, Mexico and Norway. Most of these countries are truly rentier economies, whose bulk of incomes earned are economic rents from natural resources.

All oil-rich countries, except Iraq, could increase their real GDP per capita in the boom-period 1999-2008, but at quite different rates – in most cases growth (calculated in terms of purchasing power in constant 2005 US-\$) was disappointing. Azerbaijan reached the highest average p.a. growth (15 percent), Angola did very well with 8.6 percent, Russia reached 7.3 percent and Nigeria 3.6 percent, but Venezuela managed only 2.5 percent and Mexico not more than 1.7 percent. Most countries did hardly better than OECD countries and performed clearly worse than most emerging countries, such as the BRIC-group (Brazil, Russian Federation, India, China).

The main reasons for this contrast between growth per capita and the skyrocketing energy prices in the period were that either the bulk of the revenues were saved abroad (predominantly by Near East countries and Norway) or led to high inflation which diluted the purchasing power of incomes.

The oil revenues triggered in a number of countries high or even hyper-inflation, especially in Angola (69 percent p.a. 1999-2008) and in Venezuela (20 percent p.a.) and to a much lesser extent in Nigeria (12 percent p.a.). In contrast, the majority of traditional oil-exporters like Saudi-Arabia or others could maintain price stability similar to OECD-countries. In the case of high inflation, dollarisation (crowding-out of local currency) is likely to follow. Under such circumstances a strong depreciation of the local currency can be expected, sometimes also a real depreciation of the real effective exchange rate (REER), however the local currency becomes more and more irrelevant.

Data for REER are only available for few countries. Some oil exporters suffered heavy real appreciation of their exchange rates in the boom 1999-2008, such as the Russian Federation (+90 percent), Nigeria (+36 percent), Venezuela (+36 percent) or Ecuador (+31 percent). Few managed to facilitate

a real depreciation such as Algeria (-19 percent) or Saudi Arabia (-5 percent). A substitute for the REER could be the change in the nominal exchange rate vis à vis the US-\$ adjusted for the inflation differential to OECD countries. This way, besides the Near East countries, which maintained price stability and pegged their exchange rate tightly to the US-\$, most other oil exporters suffered from heavy real appreciation, i.e. their nominal depreciation was much less than their excess inflation compared to OECD countries. Dollarisation (officially or unofficially) prevents the opportunity for nominal exchange rate re-alignments, but either implies abandoning local currency or making it almost irrelevant and, therefore, abandoning de facto domestic monetary policy. This clearly corroborates the Dutch disease diagnosis for these countries, whereas the Near East countries and some others (e.g. Norway, Mexico) were able to avoid Dutch disease worsening. This does not necessarily mean that they do not suffer from a high external value of their currency which inhibits the competitiveness of their manufacturing industries; but during the recent oil boom a further real appreciation did not occur in these countries.

The current account balances improved during the boom period strongly; on average of 17 oil countries for which data were available, the surplus in the current account was 19 percent of GDP in 2007 (peak of the oil boom), in Kuwait even above 40 percent, Nigeria reached 32 percent at the peak. In 1999, the range of current balances was between -28 percent (Angola) and 17 percent (Kuwait), on average around zero. This implies that most rentier economies had been reluctant to import more goods despite the ample oil revenues. If a balanced current account is considered the benchmark, increasing balances have to be seen as real undervaluation of the currencies; this underlines the attempt of many countries to contain the appreciation and hence the Dutch disease effects.

1. This policy brief is an extraction of the paper "Coping with Dutch Disease and resource curse in Least Developed Countries" presented at the International workshop on the "Economic Perspectives of Least Developed Countries" held at EPRC Conference Centre, Kampala-Uganda on May 24-26, 2011. The workshop was organized by Economic Policy Research Centre, Makerere Business School and HTW Berlin University of Applied Sciences.

2. Work in progress, not yet published.

As stated in theories about Dutch disease, the share of manufacturing value added in total GDP is not only small in most energy-rich countries but did not increase during the boom. In Nigeria, the share is only 2 percent, in Angola 6 percent, even in Norway only 10 percent. However, if the share remained more or less stable in the case of countries with high growth of GDP, then there was remarkable growth of manufacturing alongside GDP growth. Employment in industry is considerably bigger, as extraction industries and construction are included. Mineral commodity prices trend with energy prices, hence tend to be boom sectors as well, whereas construction is mainly a non-tradable sector benefiting from rising domestic demand during booms. Among the energy-rich countries, Indonesia is an outlier—the share of manufacturing in value added is high and rising, up to 29 percent. Typical for Near East countries, Saudi Arabia's share of manufacturing was always below 10 percent of GDP. With the exception of Indonesia, the energy-rich countries' manufacturing is much less developed compared to the average of Brazil, China and India as emerging non-rentier economies or compared to OECD-countries.

The resource-rich rentier economies can be classified in the four types:

1. External exploitation: In some economies the natural resources are exploited in a post-colonial manner by foreign companies and the revenues appropriated predominantly by foreign owners. Statistically, GDP rises during a resource boom, but due to the profit drain the current account balance increase is limited, and appreciation of the currency is weak. In such a situation there is no Dutch disease, but no new wealth for the country either.

2. Dutch disease: Either strong nominal exchange rate appreciation occurs under a floating exchange rate regime, with little inflation, or with fixed exchange rates, revenues are spent to a large extent within the country and cause inflation and thus real appreciation. In both cases growth of

manufacturing and other tradables is hampered. What is particularly important for LDCs with a low degree of industrialization is the fact that the resource boom hampers agricultural production, as agricultural exports are inhibited and imports become cheaper. This can endanger self-sufficiency in agriculture and lower employment in this sector; rural poverty might even increase.

3. Inflation and dollarisation: If the resource revenues are overspent in the country due to a pent-up “greed for spending”, be it consumption or investment-inflation maybe be likely, normally triggering dollarisation. Under dollarisation monetary policy loses effectiveness or becomes even irrelevant. Adjustments in the real exchange rates become impossible; an important policy tool is lost, so that the policy space is severely narrowed. Furthermore, since energy-rich countries are prone to asymmetric shocks, compared to the U.S., using the US-\$ as main currency is not advisable.

4. Successful mitigation of Dutch disease: Both inflation and real appreciation can be prevented or mitigated by prudent macroeconomic policies, including capital account and exchange rate management. This requires that big parts of the resource revenues are saved abroad, but kept in domestic—private or state-owned—ownership (in contrast to external exploitation), or used to import goods, mostly investment and intermediate goods, to promote development and industrialisation. Containing price stability requires that nominal wage increases are in line with the inflation rate target and productivity increases in the non-oil sectors. Oil revenues may also be used to reduce external debt and to conduct counter-cyclical fiscal policies in recession episodes.

Policy Conclusions/ Recommendations

Especially in LDCs with a strong backlog in consumption and government spending, the temptation to spend ample revenues from increased natural resource sales could be strong. Prudent and strict monetary and fiscal policy discipline is needed.

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Monetary policy has to focus the real exchange rate; fiscal policy must be more attuned to contribute to price stability. Income policy is advised to avoid inflationary distributional conflicts. Natural resource discoveries or price booms open grand opportunities to gradually improve infrastructure, to invest in housing and health provision as well as in education and to lower external aid dependence. The key challenges are to avoid inflation and real appreciation of the exchange rate, as well as to avoid a bonanza-pattern in output, in line with resource prices. The means for smoothing the cycles are provided by natural revenues. If the macroeconomic requirements are met, Dutch disease effects can arguably be mitigated, but hardly fully avoided. Otherwise the Dutch disease turns out to be a lasting resource curse. In other words, what is necessary is to transform the natural assets in man-made capital accumulation, be it infrastructure, public goods, human capital or private productive investment in manufacturing and in other modern sectors.

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