

Theories on resource course

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Introduction

The resource curse or excess availability of natural resources presents a particularly interesting analysis when it comes to economics and often underpins many of the policies and theories which can be looked at in relation to how the government can organise its own economic behaviour, so as to achieve long-term economic growth (Acemoglu, 1996). The purpose of this section of the literature review is to look at factors associated with the resource curse. In particular, the explanations of the resource curse and the way in which they may potentially be dealt will be examined, before putting the resource curse into context and then discussing measurement techniques and policy approaches and looking specifically at how these may be used in relation to the resource curse in Libya. Crucially, it is noted that there is empirical data to suggest that countries with a higher level of natural resources were also seen to be displaying trends of low economic growth (Alexeev and Conrad, 2009). This seemingly presents a potentially interesting point of analysis for those involved in developing policies that will enable a country with a high level of natural resource to achieve a better level of economic growth as a result (Alexeev and Conrad, 2009).

In the leading research undertaken by Sachs and Warner (1995, 1999, 2001), it was shown that any nation with very high levels of natural resources would typically find that it has lower economic growth, particularly when the figures are looked at in a whilst taking into account demographic, economic or political differences.

At the outset, the work by Sachs and Warner, in 1995, aimed to look at the seeming anomaly that countries with a high level of a specific resource were performing poorly, in terms of economic growth (Michaels, 2011). This issue was later the focus of many different areas of research, with specific case studies being used as a means of establishing why these natural resources were ultimately having a negative impact on overall economic growth. As a result of this, several theories emerged over the years as to why precisely the resource curse has evolved and whether there are different ways in which resources can be viewed so as to potentially reduce the impact of such natural resource excess in a country such as Libya (Bleaney and Nishiyama, 2002).

The concept that natural resources may become what was seen to be an economic curse emerged during the 1980s, with the actual terminology “resource curse” first being used in 1993 (Sachs and Warner, 1995). These theories essentially created an analysis of a counterintuitive situation whereby it was shown that countries with a high level of natural resource were not developing economic growth at the expected rate. A wide variety of studies, notably those by Sachs and Warner (1995) aimed to show the link between natural resources and economic growth, which then led to a wide variety of studies on precisely why this negative relationship appeared to exist (Mauro, 1995). As a result, a wide variety of different theories have been used as a means of describing why this relationship exists.

Theories of Resource Curse

Although there have been various research projects looking at specific explanations of the resource curse, which will be looked at in more detail below, there has also been a body of research which has looked more generally at the theories of resources and why such situations have emerged, in the first place. Each of these factors will be looked at in turn; however, a brief overview of the theory will provide strong background understanding.

Dutch Disease

One of the leading explanations to be presented in relation to the resource curse theory is that of the “Dutch Disease” theory established by Matsuyama (1992), which argues that when an organisation or country specialises in a particular type of resource production, the combination of the specialisation as well as the appreciation of the exchange rate will then result in a decline and will become more conducive to other industries which are not going to lead to the same economic growth (Lutz, 1994).

Fundamentally, it is argued that this type of resource curse can lead to other factors such as the industrial sector generally lagging behind as they are not the main driving force within the economy (Fosu, 1996). The underlying notion of this theory is that the level of expansion experienced as a result of the use of natural resources is not going to be large enough to offset the negative effect of failure to industrialise other sectors in order to support central economic growth within the relevant industrial sector. Furthermore, this type of reliance on natural resources can impact on the way in which exports are treated within countries with a high level of natural resources which will be looking towards exporting these natural resources and may

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even do so in preference to other exports, which could ultimately improve economic growth (Papyrakis and Gerlagh. 2007).

The empirical example which was used during the development of the Dutch Disease concept was used by The Economist, in 1977, when it looked towards explaining why there had been such a dramatic decline in the manufacturing sector across the Netherlands, since natural oil fields had been found eighteen years earlier. Research in the area of the Dutch Disease concept has focused on a situation whereby there has been a natural resource discovery, although it is noted that this could potentially be used as the same concept when there is any large inflow of foreign currency. For example, it could be due to substantial foreign investment or a large amount of assistance from abroad (Manzano and Rigobon, 2006).

The classical version of Dutch Disease was developed by Corden and Neary (1982), although it is noted that the actual terminology was used previously by The Economist, five years earlier, showing that the notion of Dutch Disease had been in place for several years, even if the underlying reasons and theoretical analysis took a while in being formulated. During the analysis in 1982, the research took on board the fact that certain booming sectors, such as the extraction of oil or the extraction of natural gases, are looked at alongside the lagging sectors, which would seem to be the manufacturing sectors, but also referred to other sectors, such as agriculture, depending on the nature of the country in question (Lederman, and Maloney 2003).

However, the fundamentals of the research suggested that there was a booming sector and a lagging sector and again this supports the idea that, although the issues associated with the Dutch Disease have focused on a

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natural resource boom, including the underlying reason for an economic boom in a given sector (Sala-i-Martin and Subramanian, 2003).

During this initial research, it was found that the level of resources can affect the quality of that country, in specific ways. The first being the resource movement affect whereby the resource boom increases demand for labour in that particular sector and labour is therefore diverted away from other sectors into the booming sector. The actual impact of this effect can be variable, depending on the nature of the sectors involved, where the lagging sector has not historically employed a large number of people. The second effect is that of the spending effect, which occurs as a result of the dramatic increase in resources being brought forward by the boom, in any given sector. Moreover, where there is an increased demand for certain non-traded goods, the price of the goods involved will then increase. Despite this, the prices in these sectors are set on an international basis and therefore cannot change, thus causing an increase in the real exchange rate within the country (Sala-i-Martin and Subramanian, 2003).

Given the potential merit of this argument presented in a relatively rudimentary form, back in the early 1980s, several models of international trade have looked to develop this notion in a bid either to support or disprove the argument that the Dutch Disease theory can be used to explain why resources emerge in countries, such as Libya (Meier and Rauch, 2000).

When looking at basic resource-based international trade models, it can be argued that a country will typically specialise in whichever industries have a competitive advantage within the relevant country which is particularly rich

in one or more natural resources and which, according to international trade models, would be better off specialising in the extraction and sale of these natural resources. Despite the seeming conflict with these international trade models, theories have been developed around this international trade body, which suggests that specialisation to this extent could be detrimental. For example, where the natural resource begins to dwindle and where there is a downturn in prices, the country cannot then adapt and refocus on the now lagging industries, at a rate which would make it commercially viable. Investment may also be slow from firms, particularly in the lagging sectors, which then creates an even greater gap between the booming and lagging sectors.

Research in this area has looked not only at the effect, but also at the large amount of expertise involved in focusing on minimising the impact of Dutch Disease, looking at specific examples of this type of scenario, in a bid to consider how countries such as Libya can look to minimise the effect of Dutch Disease theory, if it begins to emerge within their jurisdiction (Stern, 2008).

According to existing research, there are two key ways in which threats associated with the Dutch disease can be reduced. Firstly, the country can look towards slowing down the appreciation of the real exchange rate; and secondly, it can take measures towards boosting the way in which the lagging sector is operating, from a competitive point of view (Auty 2001). For example, the country could attempt to neutralise the revenues from the boom sector by ensuring that not all of the revenues are brought into the country, at once. By maintaining the revenues in some form of funds abroad

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and then bringing them into the country slowly, this will then reduce the negative effect discussed above, and will reduce the impact on the real exchange rate. This approach can be politically unpopular, as these types of resource booms are often seen as a means of alleviating economic harm in the region, such as poverty. It can also be difficult from a political point of view for those in charge of financial resources, at a particular point in time, who wish to secure the future of the government and will typically aim to have a legacy of success and will therefore want to utilise the financial resources available to them. Despite this, there are several examples of these types of wealth funds, such as the government pension fund in Norway, the state oil fund of Azerbaijan and the Future Generations fund, which was established in the state of Kuwait, back in 1976 (Barbier, 2005).

The second approach, which is to improve the competitiveness of other sectors, can be done through government investment in specific areas of infrastructure. Linked to this can be the approach of protectionism, although this can potentially worsen the effect of Dutch Disease. This therefore requires careful consideration by the government as to how it is going to protect the lagging sector in such a way that does not result in a false market which is simply not sustainable in the long run (Mehlum et al 2006).

Finally, although the existence of Dutch Disease has been readily accepted by various theorists in this area, difficulties do emerge when it comes to actually diagnosing whether or not a particular country is subject to Dutch Disease, at that point in time. Accordingly, improving the relationship between the increase in a particular natural resource and a decline in another sector and a change in the real exchange rate can be difficult, as <https://assignbuster.com/theories-on-resource-curse/>

these trends may actually emerge over a long period in time (Ross, 2001). For example, the Balassa-Samuelson effect refers to the situation whereby productivity increases and has an impact on real exchange rate, this will only go a small way towards explaining and diagnosing whether Dutch Disease is being experienced in an individual country, at that point in time. Even when looking at the location in which the concept of Dutch Disease has emerged in the Netherlands, there is still some debate amongst economists that the decline of the manufacturing industry in the Netherlands was actually caused by the level of spending on social services and not by a natural resource curse at all. Establishing this link can therefore be a particularly difficult element of diagnosing the Disease and can therefore be a barrier towards putting in place suitable policies to mitigate, or even remove, the impact of Dutch Disease when it does occur (Davis, 2003).

As well as the concept of Dutch Disease, there are multiple other factors which could potentially go some way towards explaining the existence of the resource curse, all of which have their own potential merit attached to them.

Political Conflict

Where a country has an immediate need for economic income often provokes conflict within society, while each entity looks to gain the most out of the natural resources that have been discovered. Conflict is obvious in some jurisdictions, with groups of people openly competing over the natural resources in their region. In many cases, the conflict can be somewhat hidden, with different groups within society all competing secretly for budgetary allocation from the government, thus creating a situation whereby the government finds it harder to operate effectively and is consistently

navigating conflict between the various groups (Bannon and Collier, 2003). This theory suggests that a country with a large amount of natural resources may be more susceptible to internal and political conflict. This, in turn, can cause difficulties for the government, when it comes to establishing a strong economic performance and a suitably robust governance structure. For example, research by Bannon and Collier, in 2003, suggested that where a country has commodity exports which make up approximately 25% of gross domestic product, it then has a 33% risk of internal political conflict, whereas if it exports just 5% of gross domestic product, the expectation of internal conflict reduces to just 6%.

Similarly, research in the area of the resource curse has shown a tendency of naturally rich resource countries to become involved in international conflict, or indeed to be the target of international conflict (Stijns, 2005). Specific examples in recent times include Iran and Kuwait, as well as Libya which has become involved in disputes with its neighbouring region of Chad. Whilst the direct link between international conflict and natural resources remains relatively unproven, the continuous unease within the relationship between Western powers and oil-rich states is evident and certainly supports at least some arguments that a state with a large amount of natural resources will be more susceptible to becoming involved in international conflict.

Rent Seeking

Further theoretical background that has emerged in the area of the resource curse is that of rent seeking, suggesting that this can be used as a means of ascertaining why there is a negative growth where there is also an abundance of natural resources (Robinson et al., 2006). Rent seeking

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behaviour, refers to the situation whereby an individual or a particular firm will look towards increasing their own share of wealth available within the country, without necessarily increasing the overall level of wealth experienced by the country as a whole (Baland and Francois, 2000) This can typically be achieved by manipulating regulatory agencies or trying to gain some form of advantage in the market, while placing others at a competitive disadvantage. This type of rent seeking behaviour, particularly from those involved in a high level of management of natural resources can then create a situation whereby those individuals benefit and the overall country does not (Papyrakis and Gerlagh, 2004).

The concept of rent seeking was developed in 1974 by Krueger and, although the modern rent seeking behaviours have little to do with the payment of a lease or property rental, but rather looking at the way in which profits and wages are divided across groups of individuals, by referring to the ways in which they control natural resources. Rent seeking behaviour refers to the attempt by an individual to obtain a proportion of income which is not reflective of their fair portion, by manipulating the environment around them, either socially or economically, in order to extract an excess rent from their activities. This is often seen to be inherently linked to the concept of corruption. Furthermore, where there is an abundance of natural resource being held within the hands of this type of individual, rent seeking behaviour becomes harmful and can result in a monopolistic power being held by a small group of individuals, without necessarily benefiting the overall welfare of the state (Torvik 2002).

By looking at the theories associated with rent seeking behaviour, there are substantial negative consequences, which can emerge and could go some way towards explaining why the resource curse can become extremely influential within certain regions. From a theoretical point of view, there is a substantial moral hazard associated with rent seeking behaviour. For example, when individual entrepreneurial tycoons within the natural resource industry are in a position where they can purchase a better regulatory environment at a cheaper rate than they would be able to otherwise, in order improve efficiency within their own operations, there is an incentive to opt towards corruption. This might involve purchasing the regulatory environment that they wish, rather than focusing on becoming more efficient, which would ultimately benefit the whole industry. Where this type of scenario emerges, there is a strong argument that rent seeking behaviour of this nature can potentially have a detrimental impact on the overall production within states. This is because rent seeking behaviour is inherently linked to the reaction of the government and situations which may be deemed to be poor governance and corruption. Rent seeking behaviour in itself, therefore, cannot be used as an explanation for the resource curse.

Furthermore, it has been argued by economists, such as Stiglitz (2012), that rent seeking behaviour can be used to explain how social inequality of income earners' living standards emerge in certain countries or regions within countries. Again, whilst this is not directly linked to the rent seeking behaviour causing the resource curse, by taking this theory one step further, it can be argued that rent seeking behaviour creates inequality, whether this be inequality of income for individuals in a country or inequality for the

treatment of particular trade sectors, e. g. inequality between the natural resources and the other industries such as manufacturing.

Corruption / Governance Issues

Volatility within natural resources can create particular challenges for the government in any country where natural resources are the dominant source of income. Simply looking at the price fluctuation of crude oil over the last few decades, it can be seen that the price of crude oil has gone as low as three dollars per barrel and has gone up as high as \$145 per barrel. This type of volatility can make it very difficult for any government, or indeed private organisation, to manage its investment and production policies so as to maximise the potential wealth available. When relying on one specific natural resource such as oil or gas that is subject to international price volatility, it can be particularly difficult when it comes to planning debt services in dealing with government planning (Davis, 2003). Even where the government is being astute and transparent, it simply does not have a crystal ball and cannot predict the future in a way that would enable it to hedge bets or to smooth out any income volatility as a result of the international market (Davis, 2001).

Linked to this is the danger that the government will enter into agreements for excessive borrowing, based on the notion that the income will continue to be lucrative and in order to support or improve an aspect of the country such as health or education (Fatas and Mihov, 2003). It may have been prudent at the point at which the debt was taken out, as sudden changes in prices and volatility within the market soon create a situation whereby the government is unable to service the debt it has have entered into. In particular, this was

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seen to cause problems in Nigeria and Venezuela, where the governments rapidly expanded their level of debt on the back of the oil boom of the 1970s, but then when oil prices dropped in the 1980s, this meant that the governments could no longer make the repayments and the debt spiralled out of control (Fosu, 1996).

In a similar way, corruption is perceived to be a potentially strong explanatory factor as to why countries with a large amount of natural resources find themselves with relatively low economic growth, overall (Fosu, 1996). In order for economic policies and growth to be used to assist in this way for long-term growth there has to be a relatively high level of transparent governance. To a large extent, it can be seen as easier to maintain authority through ensuring that resources are allocated to the dominant parties, i. e. those involved in the natural resource industry. As such, the need to build up other infrastructures, such as governance of the other sectors, has notably diminished and the regulatory structure that underlies the economy becomes underdeveloped and unable to deal with the level of income being derived. Corruption within the political parties is also becoming an issue where there is a resource rich country and the politicians are providing for themselves and not the general economy. With offshore tax havens being readily available, politicians are able to conceal this type of commercial gain to such an extent that it simply is not sufficiently transparent (Van der Ploeg, and Poelhekke, 2010).

This concern was the subject of a report written by the United States Senate Foreign Relations Committee, titled "Petroleum and Poverty Paradox". In this report, it was stated that: "too often, oil money that should go to a <https://assignbuster.com/theories-on-resource-curse/>

nation's poor ends up in the pockets of the rich, or it may be squandered on grand palaces and massive showcase projects instead of being invested productively".

Lack of Diversification / Lack of Development of Further Resources

Finally, there is also a body of research which suggests that the resource curse can be attributed to the lack of attention and investment placed on other sectors (Cotet and Tsui, 2010). More specifically, when the region is producing such a large income stream, naturally, it can be tempting to ignore other areas, and in certain developing countries, the government in question will often rely heavily on the income being derived from natural resources, without planning for the future by developing the infrastructure in such a way that other factors can also evolve alongside the natural resource boom. Also, as it is relatively common for these natural resource industries to achieve a large amount of financial return, but not necessarily to provide a large amount of jobs, it can be the case that education and intellectual knowledge is disregarded (Ding, and Field, 2005). Furthermore, when looking at the human resource element, it can be seen that the natural resources industries will typically pay a much higher salary and this will typically attract the more able individuals within the economy to focus on this particular natural resource industry (Ding, and Field, 2005). As a result, many of the more educated individuals who would be capable of showing entrepreneurial activity within other industries may be diverted from the original course of action, in order to hopefully obtain higher salaries within the natural resource industry. This can result in some form of "brain drain"

within the other industries, as more capable individuals naturally gravitate towards the higher paying salaries. As the natural resource industry begins to decline, this creates a real problem for the country, as a whole, because there is insufficient expertise present in the other industries to ensure that they can then develop to such an extent that the overall economy does not suffer (Gylfason, 2001).

Resource Curse in Libya

Having looked at the various different theories behind the resource curse and in a bid to ascertain whether or not the link between economic growth and high natural resources is somewhat accidental, or based on solid theories, it is helpful to consider the position specifically in Libya. The research theories above go some way towards potentially explaining the existence of the resource curse; however, undertaking a more detailed look at the situation in Libya should offer additional explanatory research as to how the resource curse evolves on a practical level.

Research into the position in Libya is clearly important in the context of the wider research being undertaken here. However, it needs to be borne in mind that many of the reports emanating from Libya are likely to be driven by some form of political overtones and therefore there is a need to look at the situation in this context, in order to offer a higher level of objectivity (Tsui, 2011).

Reports have suggested that it was grievances and social/economic unrest that actually lead to the revolution experienced in Libya in recent years. Oil resources in the region have allowed the country to accumulate naturally

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high levels of wealth which have resulted in many of the concerns listed above relating to the resource curse from a theoretical point of view. By the mid-1970s, Libya had an economy that was extremely focused on oil, with a lack of diversification into other sectors and industries, something which is seen to be inherent in the problems and the explanation provided for the lack of economic growth, despite a high level of natural resources (Dollar and Kraay, 2001).

Although the upward spiral due to large oil resources remained as a central part of the Libyan economy growth for over 40 years, the revolution clearly demonstrates many of the key components identified as part of the resource curse above. When looking at the situation in Libya, it has been argued that issues of corruption and weak governance has been seen to be central in creating the revolution, which effectively ended the boom period in Libya (Smith, 1976). When looking at the difficulties faced by Libya, in recent years, several different explanations have been provided, many of which are very similar to those used to explain when looking at the resources curse as a more general concept. For example, the development of human capital has become very much centred on the oil industry. This has created a large amount of inequality between those individuals who are sufficiently educated to engage with the oil industry and those who are not. This type of display in inequality has resulted in an extremely under-developed economy in all aspects other than the oil industry itself (Wheeler, 1984).

Unsurprisingly, the dramatic decline and revolution in Libya, in recent years, has created much discussion about how Libya could potentially resolve the situation and place the country in a stronger position, going forward. If it

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were true to accept that Libya had suffered from a resource curse, it is likely that the resolution can also be found by looking at how other jurisdictions have dealt with their resources and the options available to them. One body of research, for example, has looked at whether or not the Alaskan solution could potentially offer opportunities for Libya in the aftermath of the civil crisis.

According to the Alaskan Governor, in 1982, the key problem that the region faced was the lack of check and balance over how oil revenue was used, suggesting that this was the underlying reason for the high level of resources becoming a curse and not a benefit. With no control over how the income from the oil revenues is used, the key determinants for the resource curse can be seen to be experienced. For example, a high level of corruption was experienced within the political groups, all of whom were attempting to divert the natural resource revenues for their own gain. By allowing these types of diversions to take place, other industries failed to gain the investments necessary and the industry soon began to lack in both financial and human capital.

By looking at the Alaskan situation, the problem being faced in Libya can be attributed almost entirely to the fact that the revenue streams were diverted to politicians and not used for the foundation of the country or for developing a general stability within the economy, so that other industries would not lag behind and where the country would be in a position to deal with long-term development from the short-term income gain (Leite and Weidmann, 2002).

By taking this on board, it is argued that the key development for Libya, going forward, is the need to focus on ensuring that the income derived as a short-term gain, in this case from oil revenues, (although it could be in relation to any other form of short-term and immediate gain) is subsequently invested for the long-term. This would mean that the government is effectively forced into investing the wealth in a more objective and fair way.

This argument, however, is linked to the notion that, although a high level of resource has been seen to be directly correlated to low economic growth, it is not clear whether it is a case of the actual natural resources causing the low growth, or whether it is the economic and political conditions that often emerge as a result of a booming natural resource that create the knock-on effect of low growth. It is this area of questioning that remains open for further discussion and will be relevant when it comes to determining how Libya should now look towards improving its position in the long run. In order to break the cycle, the actual pattern of the cycle first needs to be understood.

Conclusion

The issue of resources and the empirical evidence that links countries which have high natural resources with low economic growth has been established in multiple different previous research papers. What is not as clear, however, is where the resource curse emanates from and in this respect there is a distinct gap in the literature, particularly in relation to the position in Libya. Therefore, in order to establish how, having suffered from the negative repercussions of the perceived resource curse in Libya, or indeed in any

other jurisdiction, and to make sure that they do not suffer from a similar fate in future, this research needs to start by identifying the root cause of the problem. The resource curse is not simply a case of cause and effect that can be easily mapped, with several potential interventions necessary to improve the overall economic conditions in similar countries, going forward

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18

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