

# [Rich resource countries and economic growth](https://assignbuster.com/rich-resource-countries-and-economic-growth/)

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#### Why have resource rich economies so frequently failed to achieve sustained economic growth?

In the late 20 th Century, Sachs and Warner extensively documented the negative correlation between a country’s resource endowment and their rate of economic growth.[1]They focussed on point-source natural resources because they can be easily traded and exploited by others. Their paper built upon previous research leading to the so-called resource curse being widely accepted. However, the explanations of the phenomenon are disputed with the constantly fluctuating prices of natural resources being a possible explanation. In addition to this, other industries could be crowded out by the export-based natural resource industry an appreciation of the real exchange rate could also be problematic. Yet, the quality of a country’s institutions could be a better explanation for low levels of economic growth because they determine the way in which natural resources are exploited and consequently the impact the natural resource shave on the economy as a whole.

The revenue brought about by natural resources tends to be extremely volatile because natural resources have a low price elasticity of supply as production cannot be altered easily altered without incurring large costs.[2]Oil prices are particularly variable because they are often affected by political instability, natural disasters and economic downturns. This volatility is problematic because it leads to uncertainty in the country and exposes the country’s economy to changes in the world price in commodities. This problem may be exacerbated if the country has not economically diversified and the majority of a country’s foreign currency comes from exports of natural resources. The fluctuating prices can lead to a risky cycle where the government spends a lot when prices are high, but have to introduce harsh austerity measures when prices drop because they can no longer afford to maintain their expenditure.[3]The unpredictability of the government’s fiscal policy may make the country less attractive to foreign investors. A dependence on a volatile primary product has been shown to inversely correlate with investment in education, foreign direct investment and overall economic growth[4]. However, if fluctuating prices were the only cause of the low rates of economic growth there would certainly be periods of significantly higher growth when prices are high. Thus, fluctuating prices alone are not enough to explain the natural resource curse.

Dutch disease is a theory that suggests the discovery of resources in a country may lead to a decline in export-oriented industries and particularly the manufacturing sector. The export of natural resources like oil could lead to an appreciation in the real exchange rate because of the increase in demand for the currency.[5]The high exchange rate could harm the manufacturing industry as their exports would consequently be more expensive than before. Thus, the manufacturing sector would be less competitive on the global market and could lead to lower economic growth in the country. The term itself was originally used to describe this process after it happened in the Netherlands after the discovery of natural gas in 1959, but it has since been observed elsewhere.[6]Russia, for example, is one of the largest exporters of natural resources in the world and has experienced an increasing real exchange rate. Oomes and Kalcheva demonstrate that Russia has also displayed the other three major signs of Dutch disease including a slowdown of the manufacturing industry, an increase in service sector growth and an increase in wage growth. While this may not be enough to conclusively state that Russia has fallen foul of Dutch disease, it does appear that likely that the country has experienced it to some degree. Furthermore, industries that compete with imports may be adversely affected as the stronger exchange rate would increase the purchasing power of consumers. The country’s labour and capital may be redistributed towards local non-tradeable sectors and the country may then lose out on the benefits of having a strong manufacturing sector such as technological progress and good management.[7]There were significant fears that the artificially high exchange rate from North Sea oil revenue would have this impact in the UK if corrective policies were not enacted.[8]

On the other hand, Dutch disease appears to be an inadequate explanation for Nigeria’s poor economic performance because the sustained increase in price of tradable goods in the 1980s and early 1990s did not improve their economic performance and because the decline of the agricultural sector was offset by the growth of the public sector.[9]Furthermore, Norway’s extraction of oil from the early 1970s has hugely improved its economic growth and allowed it to catch up with Denmark and Sweden. Its rapid growth suggests that Dutch disease is not an economic inevitability and that there are other important factors. Larsen argues that Norway’s success where so many other countries have failed is indicative of the superior quality of its pre-existing institutions, an attribute that most primary product dependent countries do not have.[10]Norway’s government explicitly discussed the problems natural resources posed in parliament and used policies to counteract these negative impacts. For example, they tried to protect the economy from excessive demand and exchange rate appreciation by establishing a Petroleum Fund abroad and paying back foreign debts.[11]The discovery of natural resources often leads to disputes over the ownership of them and rent-seeking behaviour such as civil wars which may crowd out other beneficial behaviour. Nigeria demonstrates the institutional problems with the discovery of a large pool of natural resources. Corruption and waste has ruined the country and prevented the large quantity of oil in the country from making a positive contribution to the national economy. Conflicts over ownership of oil fields such as the Biafran war of the 1960s and successive military dictatorships have not only disturbed the extraction of oil but have disrupted unrelated economic activity.[12]

Moreover, poor institutional quality leads to a lack of trust in government especially when corruption is widespread and widely known about. Multinational corporations respond to problems of corruption by taking part in enclave development where they minimise their activity in the country so that they can avoid all the problems associated with poor institutions. Large firms extract oil from these countries but process it elsewhere, which means that there is little value added in the resource rich country. Consequently, countries like Nigeria are forced to rely on exports of raw materials and there is little value added to commodities in their economies so little profit is made within the country. Overall, it seems that oil is not enough on its own to create economic and civil disturbances, but instead exacerbates pre-existing issues. In the Niger Delta, oil was discovered amidst a backdrop of weak institutions and thus conflicts and exploitation follows.[13]However, part of the problem is that the discovery of oil and consequent accumulation of wealth at the top of the political hierarchy, as Birdsall points out, may hinder the development and improvement of institutions that could have otherwise taken place.[14]

The explanation for resource rich countries lack of growth is particularly complex. The volatility of raw material prices are in part to blame for this because they lead to uncertainty in the economy and exposes the country to price changes on the global market. This is made worse by the following unpredictability of government fiscal decisions. However, the volatility is not enough to truly understand why these countries have such slow rates of economic growth. The Dutch disease is a slightly better explanation, with the export of raw materials leading to an appreciation in the exchange rate. However, multiple examples like Norway show that Dutch disease can be avoided through careful macroeconomic planning on the part of the government. This demonstrates that the most important explanation is the quality of institutions at the time of resource discovery. If they are weak, like Nigeria’s, natural resources can lead to civil conflict and economic hardship. Yet a country with strong institutions like Norway allows natural resources to boost prosperity and economic growth.

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[9] Sala-i-Martin & Subramanian, Addressing The Natural Resource Curse, p. 16

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