



Resource curse, Dutch disease and economic diversification

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Presented at

International Think Tank for Landlocked Developing Countries, UN House, United Nations Street-14, Ulaanbaatar, Mongolia



Overview

- 1. Resource curse**
- 2. Empirical evidence**
- 3. Dutch disease**
- 4. De-industrialisation**
- 5. Policy responses – options (macro and micro)**



6. Economic diversification

MSMEs

- **Finance**
- **Market connectivity (supply chains)**



1. Resource curse

Explanations:

- **Terms of trade**
- **Resource sector dominance** – backward and forward linkages do not develop
- **Dutch disease** (de-industrialisation)
- **Government policy and institutional failure** (rent seeking behaviour)



2. Empirical evidence

Resource abundance and long term economic growth:

- No consensus in the empirical literature
- Divergent performance across resource abundant economies
- Importance of institutional quality
- More likely to occur for certain types of natural resources than others. Narrow geography economic base more prone to encourage rent seeking behaviour
- Support for the resource curse hypothesis is weak across different methodologies.



3. Dutch disease

Focuses only upon the economic aspects of resource abundance, production and exporting

- **Resource production and price changes impact the real exchange rate** (appreciation) and the non resource tradables sector (export and import competing)
- **Structural change in production and relative decline in the share of non resource tradables** (manufacturing and/or agriculture for a developing country).
- **De-industrialisation**



3. Dutch disease (cont'd)

Direct and indirect transmission mechanism

Direct effect (resource movement effect) – focus on the supply side of the economy

Indirect effect (spending effect) – focus on the demand side of the economy



4. De-industrialisation

Is de-industrialisation bad for economic growth?

Manufacturing a key sector for long term growth, employment and development, not prevalent in the resources and non tradables sectors:

- Increasing returns to scale
- Interconnected activities within the manufacturing sector itself through backward and forward linkages and other sectors (agriculture and services)
- Greater efficiency through specialisation and the division of labour
- Improved labour productivity



- learning by doing effects more innovation,
- less volatile terms of trade,
- positive externalities,
- human capital accumulation, innovation, technological spillovers,

A decline in this sector may have a strongly negative impact on overall productivity, long run growth and development and be of concern to policy makers.



4. De-industrialisation (cont'd)

However, evidence on knowledge spillovers from manufacturing and exporting is mixed.

New technologies such as ICT and in the services sector is rapidly replacing traditional export sectors as new engines of growth and job creation.

Manufactured exports are not the sole source of positive externalities.



4. De-industrialisation (cont'd)

Other aspects impacting manufacturing:

Volatility and the transmission mechanism

Reduced investment in manufacturing from volatile resource prices and real exchange rate volatility.

Impact on government revenue and spending more volatile impacting government consumption and development expenditure, GDP

Impacting infrastructure spending and debt repayment



De-industrialisation (cont'd)

Government over-borrowing

Development projects and higher public consumption spending resulting in larger budget deficits.

End of boom unsustainable budget deficits and external debt. Reduced government spending with an adverse impact on long term sustainable growth.



4. De-industrialisation (cont'd)

Government weaknesses and corruption.

Ability to utilise resource revenues for long term growth is an important issue

Poor governance due to corruption, rent seeking behaviour of government officials, poor government official capacity, poorly devised development strategies and economic mismanagement, excessive public consumption spending and weak market institutions can undermine economic growth and development



5. Policy responses to the Dutch disease

Three policy options available:

1. Do nothing (microeconomic reform)

Leave to market forces

Some industries will decline while others will grow.

Government implement policies that **enhance flexibility and adaptability** – labour mobility, temporary assistance for affected industries, improved infrastructure, facilitate efficient institutions and government.

Fiscal policy is too narrow and should be broader focusing on **macroeconomic and structural policy measure, addressing country specific issues** regarding competitiveness and productivity growth.

5. Policy responses to the Dutch disease

Eliminate supply side bottlenecks (labour market rigidities, access to finance, complex business start-up procedures, cumbersome business licensing requirements) to improve economic flexibility and speed up the adjustment process.

Robust institutions, strong rule of law, consistent enforcement of regulations, free and fair competition, enabling business environment to encourage innovation, entrepreneurship and productivity resulting in enhancing the economy's competitiveness and export diversification.

Building robust institutions, reducing adjustment costs and broader competitiveness rather than protecting particular industries.



5. Policy responses to the Dutch disease

2. Piecemeal intervention.

Selected manufacturing industries receive special assistance in the form of subsidies or import tariffs

Subject to the criticisms of the infant industry argument.



5. Policy responses to the Dutch disease

3. Macroeconomic stabilisation program – fiscal surplus combined with a lower interest rate (expansionary monetary policy).

Stabilise real exchange rate

Lower interest rate leads to a depreciation of the real exchange rate (capital outflows)

Reduces the Dutch disease effect

Strategy would not discriminate between industries in the manufacturing sector, result in less economic distortions.



5. Policy responses to the Dutch disease

Fiscal policy is the main tool to deal with the negative effects of the Dutch disease. Constraining the spending effect in a low income economy (main problem)

Main objective:

Generate budget surpluses constraining the spending effect and related Dutch disease consequences

Identify how best to use the budget surpluses/savings

How much should be saved and how much invested (Futures fund, SWF)

Various funds can be established to address these issues: _____



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How should government savings (budget surpluses) be invested

Options:

1. Retire existing international debt
2. Invest domestically (establish a Futures fund)
3. Invest funds overseas (Sovereign wealth fund)



Invest funds domestically

Establish an FF – two options

1. Invest/accumulate domestic assets/wealth and in industrial development policy
2. Invest in the home economy aimed at facilitating structural change, diversifying the economic base, enhancing productivity and competitiveness of domestic firms infrastructure (transport and logistics), education and training, health, business start-ups and entrepreneurship, ability to absorb foreign technology and innovation. To be effective this requires good administration and a good coordination of government and business efforts.



Invest funds overseas

Establish a Sovereign Wealth Fund (SWF)

These are government owned funds obtained from resource exports that are entirely invested in overseas assets (stocks, bonds, real estate, private equity fund, hedge fund based overseas. (see the Government Pension Fund of Norway).

Represents:

1. A form of **national savings**
2. **Internationally diversified portfolio of financial assets and a source of future income.**
3. Enables a **lower real exchange rate through capital flows and asset accumulation**, and reduces the impact of the Dutch disease.



Invest funds overseas developing country

There is a significant opportunity cost for a developing country in terms of lost opportunity to build up domestic infrastructure and universal social protection system which could be important from a political and development perspective.

Corden believes that if the objective of the fiscal surplus combined with investment of the surplus is to moderate the Dutch disease effect from a boom, it is best to invest abroad rather than at home. A SWF would be preferred to a FF.

Degree of substitutability between domestic and foreign assets determines investment in a FF or SWF.



6. Economic diversification

MSMEs are important for an economy. Main contributions include

- Business numbers
- Output
- Employment
- Exports
- Innovation



- Poverty alleviation
- Broad and Inclusive growth
- Economic empowerment
- Wider distribution of wealth

Recognition by national and regional institutions



Importance of MSMEs to regional economies

Summarised in Table 1:

Business numbers: > 99%

Output: 20 – 60%

Employment: > 60%

Exports: 10 – 30%



Table 1 Significance of MSMEs in ASEAN economies, various years

Country	Share of total establishments		Share of total employment		Share of GDP		Share of total exports	
	Share (%)	Year	Share (%)	Year	Share (%)	Year	Share (%)	Year
Brunei Dar.	98.2	2010	58.0	2008	23.0	2008	--	--
Cambodia	99.8	2011	72.9	2011	--	--	--	--
Indonesia	99.9	2011	97.2	2011	58.0	2011	16.4	2011
Lao PDR	*99.9	2006	81.4	2006	--	--	--	--
Malaysia	97.3	2011	57.4	2012	32.7	2012	19.0	2010
Myanmar	**88.8	--	--	--	--	--	--	--
Philippines	99.6	2011	61.0	2011	36.0	2006	10.0	2010
Singapore	99.4	2012	68.0	2012	45.0	2012	--	--
Thailand	99.8	2012	76.7	2011	37.0	2011	29.9	2011
Vietnam	97.5	2011	51.7	2011	--	--	--	--

Note: *Asian Development Bank (2013), **Registered numbers.

Source: various Country reports, ERIA, 2013.



MSME opportunities, challenges and capacity building

MSME Opportunities.....



MSME Opportunities

- **Niche markets and customization;**
- **Production networks** (supply or value chains) and subcontracting;
- **Reduced product life cycles and flexible production;**
- **Global retail sourcing ;**
- Importance of the **services sector** (dominated by SMEs):
- **Knowledge, skills, and innovation** (knowledge economy), value adding, creativity
- **Reduced bureaucracy, greater flexibility,** and ability to respond to rapidly changing customer demands and technology;



- **Innovation capacity** and ability to initiate and commercialize innovation, particularly in knowledge and skill intensive sectors where entry costs are lower
- Advances in information and communications technology, and innovative utilization of **e-commerce** to expand market outreach, expansion of networks, gaining access to information, and participation in value chains
- **Networking and clustering**
- **Technology development**, adaptation, and application;
- **Recognition by national and regional policymakers**
- **Trade facilitation measures**



MSME Challenges.....

- a **lack of resources** (finance, technology, entrepreneurial and labour force skills, market access, and market information);
- a lack of **economies of scale and scope**;
- **higher transaction costs** relative to larger enterprises (e.g. transportation costs);
- **high costs in accessing and utilising ICT**, and skill deficiencies in the utilisation of ICT;
- **entrepreneurial, managerial, accounting, and marketing skill deficiencies**;
- difficulty achieving **accreditation for product quality**;
- a **lack of networks and information** on market opportunities;



- **increased market competition;**
- **inability to compete against larger firms** in terms of R&D and innovation (product, process, and organization);
- Subject to considerable “**churning**” and **instability;**
- **Geographical isolation;**
- **Lack basic skills** in dealing with customers, both in the domestic market and in the export market.
- **Limited knowledge about language and culture,** as well as the legal and bureaucratic issues involved in exporting.
- **Lack of business infrastructure (BDS) support.**
- They may be **discriminated against** relative to large firms.



- **Informal**



Capacity building – key areas.....

- *****Access to Finance
- *****Connectivity to Markets
- Access to Technology
- Access to Skilled Human Resources
- Accessing Information
- Interfirm Networking and Clustering
- Knowledge Acquisition and Innovation
- Entrepreneurship Education and Training



Thank you for your attention

