

USAID ECONOMIC GROWTH OFFICERS CONFERENCE
OCTOBER 15-19, 2007
WASHINGTON, D.C.

Session Title: The World Commodity Boom, and Can We Inoculate for Dutch Disease?

Date and Time: Tuesday, October 15, 2007 9:00am

Type of Session: Plenary

Speaker(s): R.M. Auty, A.C. Harberger

Moderator: Mark Gallagher

Overview of Session:

1. Dr. Harberger highlighted the macroeconomic effects of “Dutch Disease”, namely that a large influx of foreign exchange usually results in an increase of the real exchange rate and inflationary pressures. The recommended approach is to keep that revenue abroad and only repatriate it home as needed.
2. Dr. Auty emphasized that it is not a Resource Curse but rather a Rents Curse - whereby rents distort government incentives and a country’s economic path. This theory of rent cycling suggests 1) that economic reform requires a political strategy to resist sabotage by rent recipients and 2) the geopolitical situation is vital and contrived rent can replicate features of resource rent so improving policy is critical.

Speaker’s Remarks:

Mark Gallagher started the discussion by introducing the topics of “Dutch Disease” and the “Resource Curse” – describing the trend that countries with large resource abundance (such as oil

, natural gas, or precious metals & gems) tend to grow more slowly economically and politically. “Dutch Disease”, named for an economic crisis in the Netherlands in 1970s, describes the situation whereby high commodity prices leads to a large inflow of foreign currency leading to macroeconomic instability (including inflation and currency appreciation). Dutch Disease is usually considered an element of the Resource Curse, which also includes broader governance and socio-political issues as well as economic.

Professor Harberger, Chief Economist of USAID, has worked on the issue of Dutch Disease since about 1980 and he focused his discussion on basic macroeconomic principles. When a country receives a huge flow of foreign exchange, there will always be an equilibrium adjustment. This occurs whether under a fixed or floating exchange rate although there are differences in the dynamics between the two systems. Flexible exchange rates react more rapidly to a change while the benefit of a fixed exchange rate is that it is easier to calculate. This may lead to some cost savings however weaknesses can hide for 20 years and be severe later.

The reaction to a huge inflow, if that inflow is going to be used by the economy, must be reflected by an excess of imports over exports equal to the size of inflow. Whether the inflows

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are temporary versus permanent is also important – if its temporary, the economy may be able to adapt quickly as the initial infusion of cash can be absorbed by corresponding increased local consumption. In the long run, however, local consumption can't absorb all the increased money supply and there will be a real exchange rate adjustment with price levels rising. The best idea in this situation is usually to put that inflow of money abroad and only repatriate it home as needed.

Richard Auty looked at the issue of the resource curse from the political economy perspective, emphasizing the issue of rents.

Over time, literature has been contradictory on the resource curse – some articles stating that there is a negative correlation between growth and high value natural resource abundance while others have stated that the nature of institutions is more important than that of resources. So while there are a lot of different ideas academics haven't addressed the issue of rent flows. He emphasized that the Resource Curse is part of a broader Rent Curse and that it's actually a symptom of these rent flows.

LDCs' rent flows can destabilize economy and they include:

- Natural resource rent
- Geopolitical Rent (ie. Foreign aid)
- Contrived Rent (derived from changing relative prices)

Rent has two key impacts:

- 1) Government incentives – Government can tax increased wealth (gaining revenue). There is a strong temptation to redistribute rents for popularity so rent is then cycled through patronage channels.
- 2) Economic Path - deflects the economy from its comparative advantage and results in lower per capita GDP growth.

Auty emphasized the impacts on the economic path in two models:

For countries with low rent, he used the Low-Rent Competitive Industrial Model showing that low rent encourages industrial expansion:

- pushes you through urban transition faster, increasing propensity to save
- virtuous political circle – labor intensive exports reduces unemployment, puts a floor under the poor, so growth is relatively egalitarian. People have to pay taxes so you get pressure for political accountability. You gain helpful social capital as people move more into the private sector and proliferation of private enterprise, which puts pressure on property rights and law abiding governance. So this model tends to sanction again poor governance.

For high rent countries, he discussed the High Rent Stable Trap Model:

- a primary dependence on high income primary exports skips labor intensive exports, so those benefits are not encountered
- misses the beneficial social affects, equitable distribution of wealth push for good governances

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- unemployment is problematic, so they over-expand government and protect the market too
- become more and more dependent on the one export

Auty used Angola as an example and suggested that Angola could adapt China's dual track reform

Track 1 = stimulate dynamic market sector to absorb surplus labor and diversify economy
Track 2 = slow reform of rent-distorted sector to limit elite backlash while Track 1 builds pro-reform political constituency to neutralize elite

An example of extracted political rent is North Korea which terrorizes its neighbors to get funding.

His main conclusions are that the Resource Curse is part of a broader Rent Curse. Case studies can track how rent flows impact political incentives and economic growth to help support a rent cycling theory which suggests:

- economic reform requires a political strategy to resist sabotage by rent recipients
- recognizing that geopolitical + contrived rent can replicate features of resource rent should help improve policy.

Key Points Discussed During Question & Answer Segment:

Q: If you're disciplined enough to set up an off shore resource fund, then perhaps you don't need one in the first place?

A: The only way you can prevent the pressure for an equilibrium rise in the price level is to just keep that money abroad.

Q: During the last several years, several eastern European countries adopted currency boards – what is your opinion of them?

A: They are variants in fixed exchange rate set up – they win in clarifying expectations, so people don't doubt future value of currency. Not sure how people will feel due to the devaluing of dollar. His impression has to do with vulnerability – would be crazy for an oil country due to high volatility of price.

Q: In Africa, most don't have high resource abundance, mostly cash crops but they are really stuck. They produce crops, they have some growth in remittances, and then they get some foreign aid. All sources of foreign exchange. What is the ability of these countries to employ policies to undervalue exchange rate to provide a more diversified export base? Deliberate undervaluation of exchange rate?

A: Can you manage the real exchange rate? Not many have done it – Brazil and Chile have. Brazilian miracle period – they started with huge trade restrictions and then peeled off trade

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restriictions to get more foreign exchange. Then oil crisis and then they put on import restrictions again. But they did succeed in stabilizing.