Dutch Disease: Too much wealth managed unwisely

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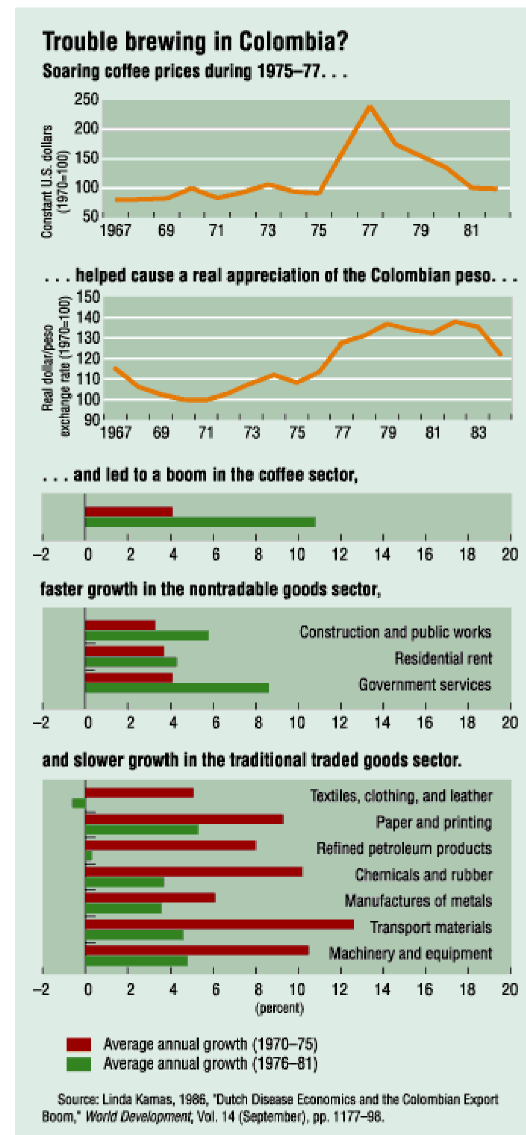
Miguel de Cervantes Saavedra, the celebrated sixteenth-century Spanish author of *Don Quixote de la Mancha*, once said that "the gratification of wealth is not found in mere possession or in lavish expenditure, but in its wise application." This was at a time when Spain enjoyed newfound access to a wealth of natural resources, including gold, from the Americas. Could he have recognized, in his own country, symptoms of what later became known as "Dutch disease," a term that broadly refers to the harmful consequences of large increases in a country's income? *Finance & Development* explores the issue.

In the 1960s, the Netherlands experienced a vast increase in its wealth after discovering large natural gas deposits in the North Sea. Unexpectedly, this ostensibly positive development had serious repercussions on important segments of the country's economy, as the Dutch guilder became stronger, making Dutch non-oil exports less competitive. This syndrome has come to be known as "Dutch disease." Although the disease is generally associated with a natural resource discovery, it can occur from any development that results in a large inflow of foreign currency, including a sharp surge in natural resource prices, foreign assistance, and foreign direct investment. Economists have used the Dutch disease model to examine such episodes, including the impact of the flow of American treasures into sixteenth-century Spain and gold discoveries in Australia in the 1850s.



The diagnosis is . . .

Why does a dramatic increase in wealth have this paradoxically adverse consequence? The answer is found in a classic 1982 paper by W.M. Corden and J. Peter Neary. These authors divide an economy experiencing an export boom into three sectors: of these, the booming export sector and the lagging export sector are the two traded goods sectors; the third is the nontraded goods sector, which essentially supplies domestic residents and might include retail trade, services, and construction. They show that when a country catches Dutch disease, the traditional export sector gets crowded out by the other two sectors.

How does this happen? Let's take the example of a country that discovers oil. A jump in the country's oil exports initially raises incomes, as more foreign exchange flows in. If the foreign exchange were spent entirely on imports, it would have no direct impact on the country's money supply or demand for domestically produced goods. But suppose the foreign currency is converted into local currency and spent on domestic nontraded goods. What happens next depends on whether the country's (nominal) exchange rate—that is, the price of the domestic currency in terms of a key foreign currency—is fixed by the central bank or is flexible.

If the exchange rate is fixed, the conversion of the foreign currency into local currency would increase the country's money supply, and pressure from domestic demand would push up domestic prices. This would amount to an appreciation of the "real" exchange rate—that is, a unit of foreign currency now buys fewer "real" goods and services in the domestic economy than it did before. If the exchange rate is flexible, the increased supply of foreign currency would drive up the value of the domestic currency, which also implies an appreciation in the real exchange rate, in this case through a rise in the nominal exchange rate rather than in domestic prices. In both cases, real exchange rate appreciation weakens the competitiveness of the country's exports and, hence, causes its traditional export sector to shrink. This entire process is called the "spending effect."

At the same time, resources (capital and labor) would shift into the production of domestic nontraded goods to meet the increase in domestic demand and into the booming oil sector. Both of these transfers would shrink production in the now lagging traditional export sector. This is known as the "resource movement effect."

These effects played out in the oil-rich nations in the 1970s, when oil prices soared and oil exports rose at the expense of the agricultural and manufacturing sectors. Similarly, higher coffee prices in the late 1970s (after frost destroyed Brazil's coffee crops) triggered a boom in coffee sectors in producers like Colombia at the expense of the traditional export sector as spending and resources were reallocated to the nontraded goods sector (see chart).

. . . bleak?

Is the damper on the lagging traded goods sector really a problem? Some economists say no if the higher inflows are expected to be permanent. In these cases, they say, Dutch disease may simply represent the economy's adaptation to its newfound wealth, making the term "disease" a misnomer. The shift in production from the tradable to the nontradable sector is simply a self-correcting mechanism, a way for the economy to adapt to an increase in domestic demand.

But other economists argue that even a permanent change is worrisome. When capital and labor shift from one sector to another, industries are forced to shut down and workers have to find new jobs. This transition—no matter how brief—is painful, both economically and politically. Economists also worry that a shift in resources away from manufacturing sectors that generate "learning by doing" might jeopardize a country's long-term growth potential by choking off an important source of human capital development. The bottom line is that, regardless of whether these changes are seen as a problem, policymakers must help the economy cope with their ramifications.

Doctor's orders

What can policymakers do? A lot will hinge on whether the newfound wealth is temporary or permanent. In countries that expect new resource discoveries to be depleted fairly rapidly, aid flows to be temporary, and terms of trade gains to be transitory, policymakers

may want to protect the vulnerable sectors—possibly through foreign exchange intervention. The sale of domestic currency in exchange for foreign currency—that is, the buildup of official foreign exchange reserves—tends to keep the foreign exchange value of the domestic currency lower than it would otherwise be, helping to insulate the economy from the short-run disturbances of Dutch disease that will soon be reversed. But there remains the challenge of ensuring that the buildup of reserves does not lead to inflation and that the country's additional wealth is spent wisely and managed transparently through, for example, a central bank account or a trust fund.

In countries whose newfound wealth is likely to be permanent, policymakers need to manage the inevitable structural changes in the economy so as to ensure economic stability. They may want to take steps to boost productivity in the nontraded goods sector (possibly through privatization and restructuring) and invest in worker retraining. They may also want to continue to diversify exports to reduce dependency on the booming sector and make them less vulnerable to external shocks, such as a sudden drop in commodity prices.

Whether exercising prudence in managing new riches or changing the course of the economy to adapt to new circumstances, such wise application of wealth would, undoubtedly, have won Cervantes's approval.