

## Dutch Disease: A Threat to Latin America's Current Growth Spurt?

Albert Berry

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Latin American economies have, for the most part, always had primary products as an important component of their exports. Eventually, the initially relatively open and commodity-based economies became less so as the region imposed more protectionist policies after the Second World War. The Import Substitution Industrialization (ISI) period saw the fastest extended growth spurt Latin America had ever seen, at about 5.5 per cent from the end of the war until the debt crisis of the early 1980s. From the onset of the debt crisis to the early years of the present decade, regional growth has been discouragingly slow: just two per cent between 1980-2003 (marginally above population growth of 1.85 per cent). Further, the last quarter century has seen a tendency towards increasing income inequality.

But in terms of overall economic growth, Latin America turned a corner beginning in 2004, reaching an average of 5.5 per cent between 2004-2007. This turnaround is widely attributed to the commodity price boom combined with fast world growth in general, creating strong markets for the products of the region. Even with a recession now threatening the U.S., fast growth in China, India and other countries may sustain the commodities boom for some time. Most prominent among those commodities are the fossil fuels that provide energy – oil, gas and coal.

One of the great questions now surrounding Latin America's medium-term economic future is whether a continued boom in fossil fuels and other commodities will bring with it some of the undesirable effects associated with "Dutch disease", a problem named for the negative after-effects of a gas export boom experienced by the Netherlands in the 1970s.

The most obvious of the worrisome effects of such booms is that they discourage the production of other "tradables" – a category made up of the goods and services that can be traded internationally (in contrast to "non-tradables" that cannot, such as construction and personal services). Tradables are mainly agricultural products, minerals and manufactures, together with certain services. When a country exports more oil (or gets a higher price for the oil it exports) this raises the country's foreign exchange earnings and makes it less important to export other goods and services in order to be able to import items not easily produced at home. The mechanism whereby the boom discourages production of other tradables is, in most countries, the exchange rate. An export boom appreciates the country's exchange rate, which in turn makes it less profitable to export other items and cheaper to bring in "importables."

Why should the discouragement of the production of other tradables be a source of concern? This depends partly on whether retaining strength in some of the discouraged sectors matters to the country's successful growth in the future. There are two main mechanisms through which it might. The first is related to the possible volatility of export revenues. Suppose that the current commodities boom lasts another decade, not too long but long enough to weaken some other tradables sectors. Then, when the commodity boom is over and the countries once again need those other sectors, their capacity has been diminished, the resources have shifted elsewhere and it may be difficult and costly, if possible at all, to restore them to their former productive levels. This may be called the "instability" cost of Dutch disease.

A different sort of damage is done if one or more of the sectors that shrink have a special role in the overall growth process. Many economists feel that manufacturing sectors, (or some key types of manufacturing such as the production of capital goods) play that role because their presence helps to increase productivity in other sectors (i.e., produces “externalities” in economic jargon). When they shrink, whether permanently or temporarily, the economy’s future growth potential is impaired.

Historically, employment and the weight of manufacturing in Latin America’s output rose over most of the 20th century, especially during its high-growth third quarter, and had reached around 25 per cent and 16 per cent respectively by 1980. But since then, these figures have plunged to about 18 per cent and under 12 per cent, respectively.

Dutch disease can also hurt overall employment and income distribution when, as is often the case, the production of the booming exportable creates very few jobs and the sectors that shrink, or whose growth is discouraged by the boom, are more labour intensive. Thus oil, gas and coal production creates virtually no jobs but their export discourages agriculture and manufacturing, sectors that create many jobs. So the net effect on the demand for labour can be negative even as total GDP is rising.

In concrete terms this “employment problem” manifests itself in some combination of higher unemployment and underemployment, lower wages, and a large informal sector of micro enterprises and the self-employed. Latin America is famous for its level of income inequality and the large share of people engaged in low productivity, informal sector jobs.

The distributional effects of commodity export booms depend greatly on who controls the export. If it is a crop produced by a few large farmers (e.g., soybeans in Paraguay) an

increase in poverty is an unsurprising result. When it comes from many small farms (e.g., coffee in Costa Rica and Colombia) the distributional effects would normally be positive. When the revenues go largely to the state (e.g., state-owned oil) the distributional outcome can go either way depending on how the state behaves.

Who undertakes oil and gas production (public or private sector) in Latin America depends on the country, as do the regulations guiding private sector exploitation. Although good offsetting policies could counteract the negative Dutch disease effects mentioned here, such policies have seldom, if ever, been much in evidence in Latin America, especially those that would help keep the demand for labour high.

Dutch disease constitutes at least some degree of threat in Venezuela, Bolivia, Ecuador, Mexico, Colombia and Brazil. The threat is currently greatest in Venezuela and Bolivia. In fact, Venezuela’s stagnation in the wake of the previous oil price hikes of the 1970s qualifies it as a classic victim of this disease: slow growth as manufacturing and agriculture are hamstrung by the appreciated exchange rate; low employment creation in productive sectors; and the resulting high levels of “informalization” and inequality. Bolivia’s level of inequality still shows Dutch disease’s impact on tin from earlier times. Mexico (now) and Brazil (when its oil becomes a major export) are less likely to suffer ill effects from energy exports because they are bigger, more diversified countries, and probably also because their decision-makers will have a better handle on how to deal with the problem.

Colombia and Ecuador are intermediate cases. Both suffer rather severe employment problems, albeit for a variety of reasons, and this means that energy exports bring a threat of negative effects along with their benefits. All these countries would do well to reflect on

how Norway has managed its energy bonanza — it is perhaps the only country in the world that rates high for its performance in that regard.

At this point, it is too early to tell whether the current commodity boom is bringing strong Dutch disease effects. In-depth analyses of the impacts of current energy exports on

manufacturing and other tradables, as well as on labour market outcomes and inequality, tend to come with a substantial lag.

*Albert Berry is Professor Emeritus of Economics at the University of Toronto, with a research focus on the economics of Latin America.*