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an eye on east asia and pacific

13 The Dutch Disease: Some Lessons for Mongolia

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Mongolia is at the brink of a huge economic expansion as its vast mineral assets are exploited. Once production at the Oyu Tolgoi copper mine begins, and as output from the Tavan Tolgoi coal deposits is scaled up, GDP growth is expected to rise to over 20 percent in 2013. Large knock-on effects on other parts of the economy are also expected, notably those related to transport, infrastructure and utilities as these too are developed to get the minerals out of the ground and on to the market. And government revenues will grow at dramatic rates.

However, paradoxically, countries richly blessed with resources like Mongolia often fall prey to the natural resource "curse"[1]. On average, for instance, resource-rich countries grow slower than resource-poor countries. Part of the "curse" is that, again on average, resource-rich countries suffer from weak political and economic institutions[2]. However, the timing of the resource discovery matters: if they are discovered when good institutions are already in place, the rents for the resources are, on average, not captured by exploitative elites, but used to promote national welfare (Collier & Goderis, 2007)[3]. Mongolia fortunately falls into this category, as it was already one of the freest and most democratic societies in East Asia when the large mining projects were discovered.

What lessons can be drawn, then, from countries which, like Mongolia, had good institutions in place when the resources were discovered, so that their main challenge was to manage the more purely macroeconomic challenges flowing from the exploitation of the resources, also known as the Dutch Disease? In fact, what happened to the Netherlands? Did it find a cure?

An appreciating currency...

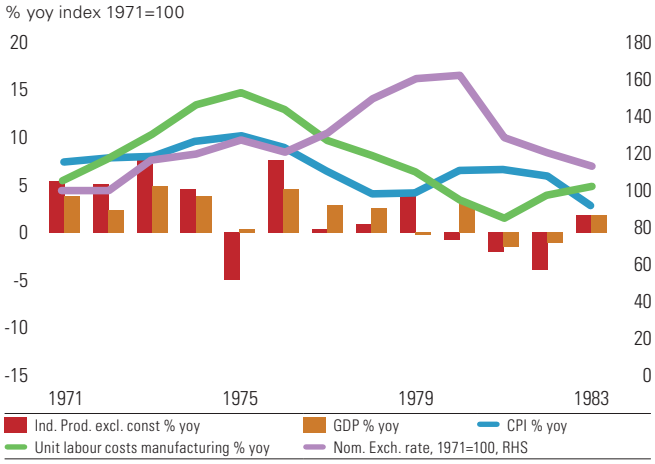
The first challenge facing resource-rich economies is that the inflow of foreign currency into the economy either drives up the nominal exchange rate, or the prices of non-tradable goods and services (for instance, wages) relative to the prices of traded goods and services. Both cause a real appreciation of the currency. This hurts exporting and import competing firms by undermining their competitiveness. In addition, resources (capital and labor) shift from the traded to the non-traded sectors, as the latter become more profitable. This further contributes to the decline of the export and import-competing sector.

1 The seminal publications are: Auty, Richard, 2001, Resource Abundance and Economic Development, World Institute for Development Economics Research (Oxford University Press); and Sachs, Jeffrey, and Andrew Warner, 2001, "The Curse of Natural Resources," European Economic Review (Elsevier), vol. 45(4-6), pages 827-838, May. For a recent survey of the literature: Frankel, Jeffrey, 2010, "The Natural Resource Curse: A Survey," 2010; WP 195, May 2010, Harvard CID.

2 The theory is that "point-source" resources such as oil and minerals lead to poor institutions because they create an often unhealthy political contest between elites to try to capture the rents from these resources, whereas in resource-poor economies only economic growth through market development will create wealth, and this type of development depends on government being able to create the type of institutions which allow for markets to thrive such as secure property rights, the rule of law and institutions which foster broad-based access to economic opportunities (Frankel, 2010).

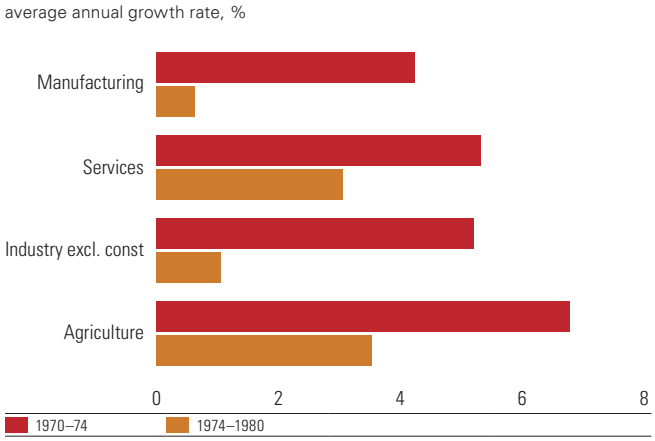
3 Collier, Paul, and Benedikt Goderis, 2007, "Commodity Prices, Growth, and the Natural Resource Curse: Reconciling a Conundrum," Centre for the Study of African Economies Working Paper Series, 274.

Figure 1. GDP, industrial production, inflation, unit labor costs and the nominal exchange rate in the Netherlands



Sources: AMECO EU, Haver.

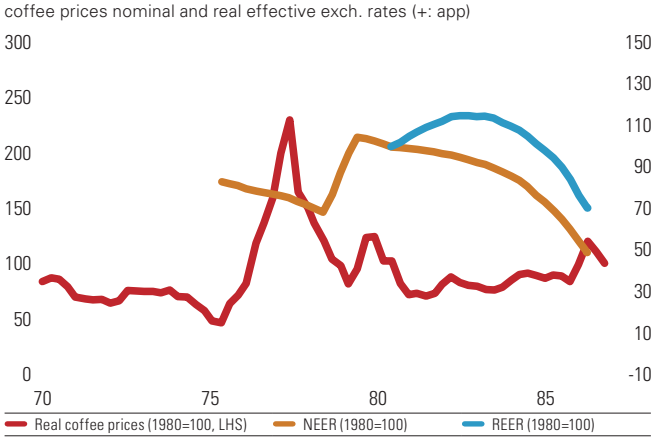
Figure 2. Average annual growth rate, by sector in the Netherlands



Sources: AMECO EU.

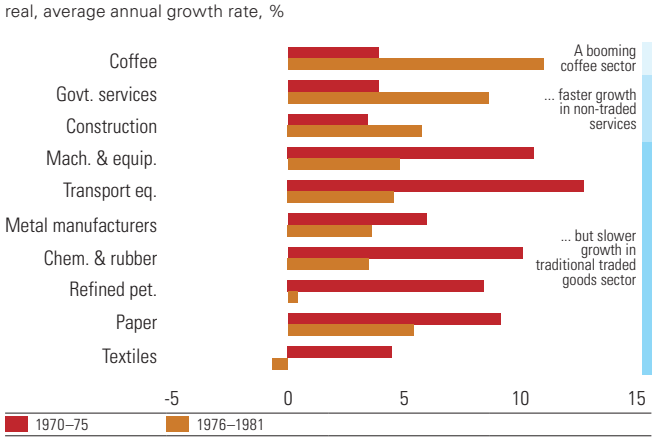
This is what happened to the Netherlands after it discovered large natural gas deposits in the 1960s. When the oil price shocks of 1973 and 1979 occurred, rising wages undermined the competitiveness of the traditional export sectors, squeezing its profitability. The income share of capital fell from around 17 percent in 1970 to less than 6 percent by 1980 with the enterprise sector barely profitable according to some estimates[4]. Average annual growth in the manufacturing sector, for example, fell from 4.2 percent in 1970–74 to 0.7 percent in the following half of the decade.

Figure 3. Coffee prices and exchange rates, Colombia



Sources: Haver, World Bank. No data for nominal and real effective exchange rates prior to 1975 and 1980 respectively.

Figure 4. Sector growth, Colombia



Source: Kamas, 1986, 'Dutch Disease and the Colombian export sector', World Development.

Another example of a country that faced a strong real appreciation of its currency due to rising commodity prices is Colombia, when a sharp increase in international coffee prices in the late 1970s (triggered by a frost in Brazil which destroyed its crop) led to a boom in its coffee producing sector. As was the case in the Netherlands, this came at the expense of much slower growth in other export sectors as resources were shifted from the traded to the non-traded sectors (Figures 3 and 4).

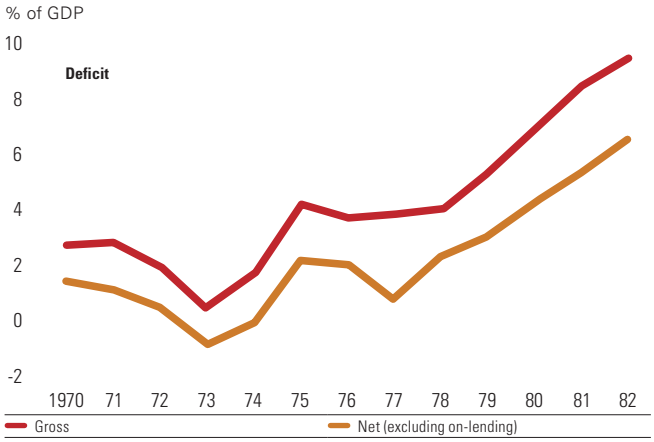
4 Bas Berend Bakker, Ioannis Halikias, Jan Kees Martijn and Maxwell Watson (1999) "The Netherlands: Transforming a Market Economy." No 181, IMF Occasional Papers from International Monetary Fund.

...and a ballooning budget

The second challenge, compounding the economic challenges caused by a real appreciation of the currency in the Netherlands and many other resource-rich countries, is sudden, large increases in government spending, often on wages and social transfers. As the revenues from the resource exports grow, governments find it difficult to resist immediate and sharp increases in spending.

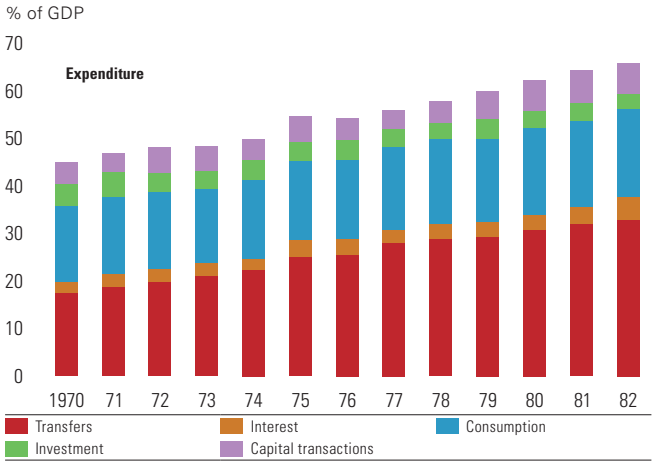
In the case of the Netherlands, public sector deficits grew as the government borrowed against future gas revenues and started an ambitious welfare program, later coined "the Welfare State", in which government would take care of its citizens from cradle to grave, without asking much in return. Public expenditures rose from 45 percent of GDP in 1970 to 66 percent in 1982 mostly due to rising transfers and social welfare payments to households (Figures 5 and 6). The expansion of the public sector was also reflected in rising numbers of public sector employees. These increased by one-fourth in the 1970s while private sector employment actually fell (by 5 percent) during that the period. It also introduced a system of coordinated and automatic inflation adjustment of wages, sector by sector.

Figure 5. Rising budget deficits in the Netherlands...



Source: Bakker et al (1999).

Figure 6. ...mainly due to sharp increase in expenditures on social transfers



Source: Bakker et al (1999).

These policies further contributed to making exports uncompetitive, the overheating of the economy, an upward wage price spiral and a housing boom which, when it went bust, contributed to a severe downturn in the 1980s. Meanwhile the nominal exchange rate was pegged to the German DM, which was less than credible (and was subject to speculative attacks during the 1970s) given that Dutch inflation was much higher than German inflation.[5]

This combination of the negative effects of real currency appreciation on competitiveness and the sharp increases in unproductive government spending on the economy would become known as the "Dutch Disease".

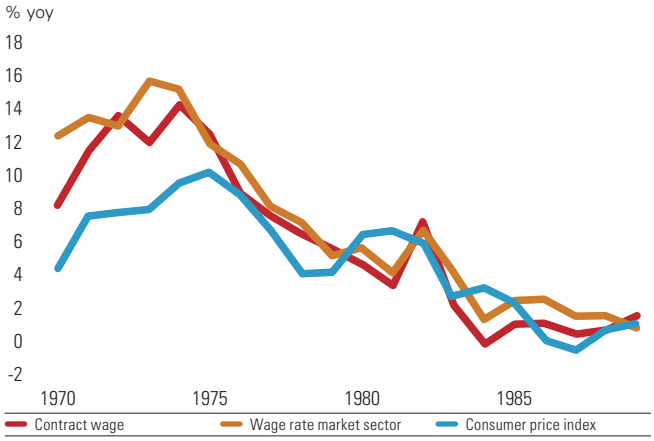
Curing the disease

In 1982, a new government took office and embarked on comprehensive structural reforms. These included a firm monetary anchor, fiscal consolidation and social security reforms, and the establishment of a gas fund for resource revenues. One crucial, albeit painful, reform was the Wassenaar Accord of 1982. This tripartite pact between the government, unions and firms laid the foundations for a labor market recovery and boosted competitiveness by limiting wage increases, tightening unemployment benefits, and removing barriers to part-time work. Essentially, the unions promised to deliver sustained pay restraint and moderation (Figure 7) relative to Germany, the Netherlands' main competitor. The unions would help to restore

5 Bas Berend Bakker, Ioannis Halikias, Jan Kees Martijn and Maxwell Watson (1999) "The Netherlands: Transforming a Market Economy." No 181, IMF Occasional Papers from International Monetary Fund.

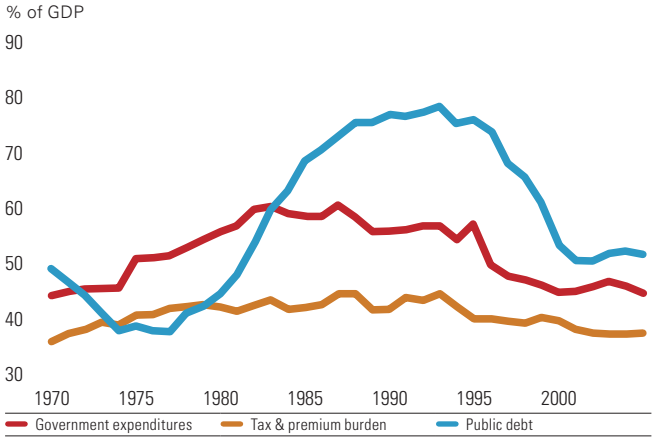
the profitability and competitiveness of firms in exchange for a new emphasis on jobs. For its part, the government undertook to clean up its fiscal books and to lower taxes (Figure 8).

Figure 7. Wages and inflation in the Netherlands



Source: Remco van der Molen, Dutch MOF.

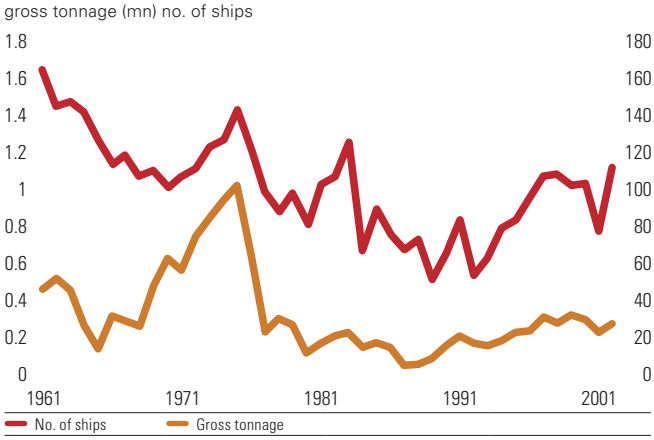
Figure 8. Government spending



Source: Remco van der Molen, Dutch MOF.

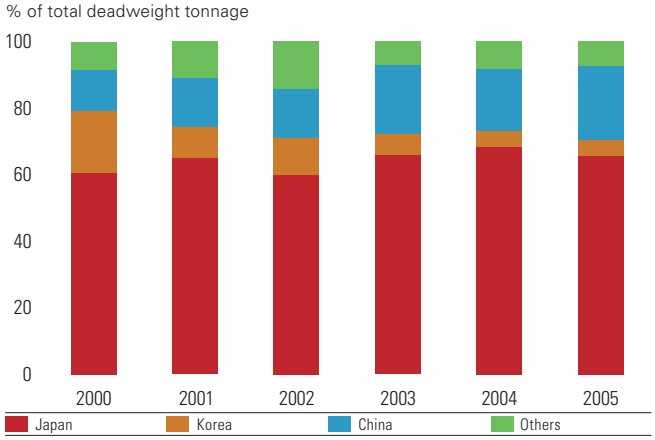
The restructuring of the economy that followed was painful, particularly the restructuring in the manufacturing sector. For instance, the Dutch ship industry which had been a leading global shipbuilding center since the 16th century and which at its height in the early 1970s directly employed some 50,000 people, would never really recover[6]. The industry currently only hires about 14,000 people[7] and, in terms of the production of large shipping vessels, has long been overtaken by producers in the Far East (Figures 9 and 10).

Figure 9. Impact of Dutch Disease on shipbuilding



Source: Niko Wijnolst, Jan Inge Jenssen and Sigbjørn Sødal (2003). European Maritime Clusters.

Figure 10. Global market shares of bulk carrier production



Source: Informare (2005), http://www.informare.it/news/forum/2006/brs/newbuilding-auk.asp

Fortunately, other non-traditional sectors of advantage emerged as the economy recovered. For example, the Netherlands currently supplies about 60 percent of the world's flowers and is the third largest exporter of agricultural goods globally, especially products related to dairy farming and horticulture[8]. Aside from a niche in horticulture, it has also developed thriving clusters in technology-intensive sectors such as biotechnology, fine chemicals, food, pharmaceuticals, electronics and ICT and medical technology. The result is that aside from flowers, machinery and equipment, chemicals, fuels and foodstuffs are also major export earners for the Dutch Economy.

6 http://www.globalsecurity.org/military/world/europe/industry-nl-shipbuilding.htm

7 http://www.cbs.nl/en-GB/menu/themas/industrie-energie/publicaties/artikelen/archief/2009/2009-2936-wm.htm

8 http://www.thomaswhite.com/explore-the-world/netherlands.aspx

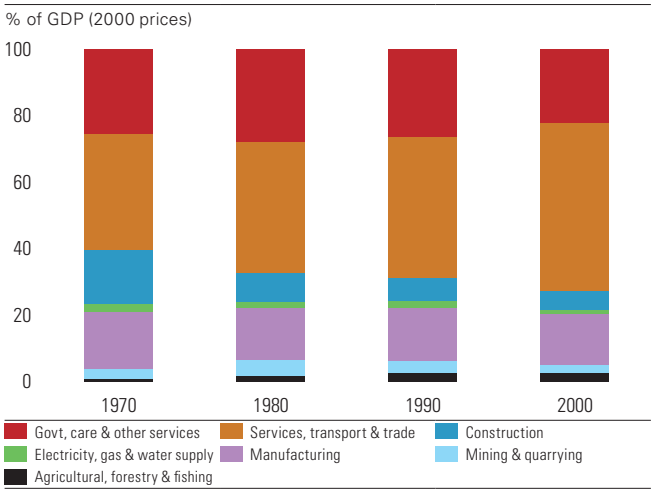
The tripartite social pact agreed to in 1982 between government, labor and business was not a quick fix. For instance, once institutions such as inflation-indexing of wages and generous social welfare benefits had been established, they were politically very difficult to undo. Hence, only gradual change was possible, and the conservative, frugal policies agreed to by the economic stakeholders had to be pursued for more than a decade to yield results. In the event, the consistent and sustained conservative management of the economy paid off: by the mid 1990s, the Dutch economy was completely cured from the "Dutch disease", and instead became better known as a European success story called the "polder model". This model continues to be based on a political culture of fiscal conservatism and coordinated, but voluntary, wage restraint. Within the eurozone, it weathered the 2008 global financial crisis very successfully[9].

The main leader from labor's side signing the Wassenaar Pact based on wage restraint was Wim Kok, the son of a carpenter. He was heavily criticized from the political left for signing the Pact. However, in 1989, he became Minister of Finance and in 1994, he became Prime Minister. He held the post until 2002. He is widely credited as being the architect of the Dutch Polder model and its successful results in terms of job creation.

Avoid the Dutch Disease, proceed straight to the Polder Model?

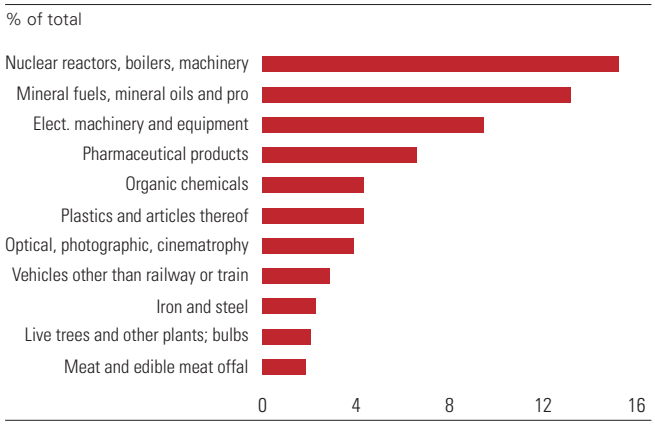
The story of the Netherlands is of relevance to Mongolia. How does a democracy with good institutions deal with the sudden discovery of mineral wealth? Initially, the Dutch followed a path which would later become known as the Dutch Disease: a strongly appreciating currency made the non-mineral sector uncompetitive, further aggravated by highly inflationary and unproductive government spending on wages and social transfers. Undoing the negative effects of the wage spiral and the overly generous social welfare system was painful and took more than a decade. The cure for the Dutch Disease was based on a voluntary, negotiated agreement between the same stakeholders which had been responsible for the Dutch Disease—government, labor and business. It was centered on conservative fiscal policies, including low public debt, and wage restraint. The essence of this agreement formed the basis of the subsequently highly successful Polder Model—a framework which also held up very well during the 2008 global financial crisis.

Figure 11. Structure of the Dutch economy



Source: CBS (Dutch Statistics Office).

Figure 12. Top 15 Dutch Exports, 2009



Sources: WITS, World Bank.

Mongolia has laid a strong legal foundation for a similar macroeconomic and fiscal framework in the three rules which form the basis of the Fiscal Stability Law passed with overwhelming majority in parliament in June 2010. The three rules put strict limits and ceilings on the fiscal deficit, expenditure increases and public debt. However, the essence of the FSL only kicks in 2013, when a structural fiscal deficit of no more than 2 percent of GDP needs to be adhered to. In the transition

9 The Dutch 'Polder Model:' What Accounts for its Surprising Resilience in the Wake of the Global Crisis? Paulette Kurzer, School of Government and Public Policy, University of Arizona. kurzer@arizona.edu. Presented at European Responses to Economic Crisis: Lesson for the US, April 7-8 2011, Indiana University, Bloomington.

period, Mongolia would do well to heed the lessons from Holland: curing the Dutch Disease can be long and painful. Preventing the Dutch Disease to afflict the economy in the first place would be the wiser path to take, and, if the story of the Polder Model holds true, will also reward the politicians associated with this path.

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