

The Dutch Disease: Lessons from Norway

by Thorvaldur Gylfason*

In the original sense of the term, the ‘Dutch disease’ refers to the fears of de-industrialization that gripped the Netherlands as a result of the appreciation of the Dutch guilder that followed the discovery of natural gas deposits within the country’s jurisdiction in the North Sea around 1960. The appreciation of the currency following the gas export boom reduced the profitability of manufacturing and service exports. Total exports from the Netherlands decreased markedly relative to Gross Domestic Product (GDP) during the 1960s. The expansion of petroleum exports in the 1960s reduced other exports disproportionately. Many feared dire consequences for Dutch manufacturing. Even so, the problem proved short-lived. From the late 1960s onwards, exports of goods and services have increased from less than 40 per cent of GDP to 65 per cent, a high ratio by world standards. The fears of de-industrialization did not materialize, but the name stuck. It is sometimes said that, being neither Dutch nor a disease, the Dutch disease is a double misnomer. But when, as in this case, a disease bears the name of the first patient diagnosed with it, it would seem a bit harsh to require the patient to remain sick for the name to stick. The fact that the Dutch recovered fairly quickly from the disease that bears their name, while some other countries have suffered much longer and continue to do so, does not by itself call for a name change.

Is it a disease? Some view it as matter of one sector’s benefiting at the expense of others, without seeing any macroeconomic or social damage done. Others view the Dutch disease as an ailment, pointing to the potentially harmful consequences of the attendant reallocation of resources – from high-tech service industries to low-tech primary production, for example – for economic growth and diversification.

An overvalued currency was the first symptom associated with the Dutch disease, but subsequently several other symptoms came to light. Natural resource dependence tends to be accompanied by booms and busts: the prices and supplies of raw materials fluctuate a

* Professor of Economics, University of Iceland; Research Fellow, CEPR and CESifo; and Research Associate, CESifo, University of Munich. Address: Faculty of Economics and Business Administration, University of Iceland, 101 Reykjavík, Iceland. Tel: 354-525-4533 or 4500. Fax: 354-552-6806. E-mail: gylfason@hi.is

great deal in world markets. Fish stocks, for example, are notoriously volatile. Oil wells go dry, mines are depleted. The resulting fluctuations in export earnings trigger exchange rate volatility, perhaps no less so under fixed exchange rates than under floating rates. Unstable currencies create uncertainty that tends to hurt exports as well as foreign investment. Further, the Dutch disease can strike even in countries that do not have a national currency of their own. In this case, the natural-resource-based industry is able to pay higher wages and also higher interest rates than other industries, thus making it difficult for the latter to stay competitive. This problem can become particularly acute in countries with centralized wage bargaining (or with oligopolistic banking systems, for that matter) where the natural-resource industries set the tone in nation-wide wage negotiations and dictate wage settlements that other industries can ill afford. In one or all of these ways, the Dutch disease tends to reduce the level of total exports or skew the composition of exports away from manufacturing and service exports that may be particularly conducive to economic growth over time. Exports of capital – i.e., inward foreign direct investment – may also suffer.

The Netherlands recovered quickly from the Dutch disease, and have seen a persistent upward trend in their total exports relative to GDP since the mid-1960s. Norway's total exports, on the other hand, have risen slowly relative to GDP to a level well below that of the Netherlands (44 per cent in Norway in 2004 compared with 65 per cent in the Netherlands), even if the Dutch economy is almost three times as large as that of Norway. Also, the share of manufacturing exports in total exports was 70 per cent in the Netherlands in 2004 compared with 19 per cent in Norway. These things matter because exports and manufacturing are good for growth. Openness to trade stimulates imports of goods and services, capital, technology, ideas, and know-how. The Dutch disease is a matter of concern mainly because of its potentially deleterious consequences for growth.

Experience seems to suggest six main channels of transmission from natural resource dependence to sluggish economic growth. At the top of the list is the Dutch disease as described above. In second place, huge natural resource rents, especially in conjunction with ill-defined property rights, imperfect or missing markets, and lax legal structures, may lead to rent-seeking behavior that diverts resources away from more socially fruitful economic activity. The struggle for resource rents may lead to a concentration of economic and political power in the hands of elites that, once in power, use the rent to placate their

political supporters and thus secure their hold on power, with stunted or weakened democracy and slow growth as a result. Extensive rent seeking – i.e., seeking to make money from market distortions – can breed corruption, thus reducing both economic efficiency and social equity. Third, natural resource abundance may imbue people with a false sense of security and lead governments to lose sight of the need for growth-friendly economic management, including free trade, foreign investment, bureaucratic efficiency, and good institutions. Incentives to create wealth through good policies and institutions may wane because of the relatively effortless ability to extract wealth from the soil or the sea. Fourth, abundant natural resources may likewise weaken incentives to accumulate human capital, even if the rent stream from the resources may enable nations to give a high priority to education. Fifth, natural resource abundance may blunt private and public incentives to save and invest in real capital no less than in human capital and thereby reduce economic growth. Sixth, natural resources are a fixed factor of production and hence impose a restriction on economic growth potential by causing a growing labor force and a growing stock of capital to run into diminishing returns.

In sum, an abundance of natural capital, if not well managed, may erode or reduce the quality of human, physical, social, and foreign capital, and thus stand in the way of rapid growth. Manna from heaven can be a mixed blessing.

The list of natural-resource-abundant countries beset by economic and political difficulties is a long one, but it does not include Norway, the third largest oil exporter in the world after Saudi-Arabia and Russia. Norway has charted a long-run-oriented, tax-based approach to the management of its vast oil resources. By law, the title to petroleum deposits on the Norwegian continental shelf is vested in the State. Thus, all the rent from oil and gas should accrue to the Norwegian people through their government. This constitutes the legal basis for government regulation of the petroleum sector as well as for its taxation. Exploration and production licenses are awarded for a small fee to domestic and foreign oil companies alike. It was decided to expropriate the oil and gas rent through taxes and fees as well as direct involvement in the development of the resources rather than through sales or auctioning of exploration and production rights. Through its direct partnership with licensees as well as through various taxes and fees, the Norwegian State has managed to absorb about 80 per cent of the resource rent since 1980. The oil revenue is deposited in the

Government Pension Fund (the name was recently changed, before it was called the Norwegian Petroleum Fund). The fund is currently about USD 300 billion, or about USD 65,000 per person, and is divided between mostly foreign bonds (two thirds) and equities (one third). As the name change suggests, the fund is intended to benefit the current generation of Norwegians in old age as well as future generations. Another aim has been to shield the domestic economy from overheating and possible waste. Even so, a variable proportion of each year's net oil-tax revenue is transferred to the government budget, essentially to cover the non-oil budget deficit. The Norwegians have not been tempted to expand their central government beyond reasonable limits as a result of the oil boom. Even 30 years after discovering their oil, the Norwegians have a smaller central government than Denmark and Sweden next door. As soon as the Bank of Norway was made, by law, more independent from political interference a few years ago, the management of the oil fund was transferred from the Ministry of Finance to the Bank to increase the distance between the politicians and the fund.

Norway's tradition of democracy since long before the advent of oil has probably helped immunize the country from the ailments that inflict most other oil-rich nations. Large-scale rent seeking has been averted in Norway, investment performance has been adequate, and the country's education record is excellent. The proportion of each cohort attending colleges and universities in Norway rose from 26 per cent in 1980 to 80 per cent in 2003. Even so, Norway faces challenges. Some (weak) signs of the Dutch disease can be detected, notably sluggish exports and foreign direct investment and the absence of a large, vibrant high-tech manufacturing industry as in Sweden and Finland next door. But perhaps the main challenge is to make sure that the oil wealth does not instill a false sense of security, a feeling that anything goes and that difficult decisions can be deferred or avoided. An effort has been made to immunize the fund from political interference by handing its management over to an independent central bank. Another possibility would be privatization, by, for example, turning the oil fund over to the people in the form of pension savings. Yet another solution might be to invest the authority to dispose of the oil revenues in a special independent, yet democratically accountable and fully transparent authority. A mixed strategy could also be envisaged, with shared public and private responsibility for the disposal of the oil wealth to spread the risks and reconcile different points of view.