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## To What Extent does the Dutch Disease Affect Development of Democracy and the Economy in Oil-rich CIS States?

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The affects of the Dutch Disease on former Soviet republics, which experienced resource abundance in the period of transition, is limited. The limits of the affect are due to several characteristics, which are attributed in the literature to the Dutch Disease, and their interaction with the structural conditions and the dynamics of the post Soviet transition to democracy and market economy. This essay will discuss the characteristics of the Dutch Disease and its possible impacts on developments of the economy, looking at the Dutch Disease as a phenomenon that interacts with structural and institutional conditions within the economy. It will also point towards other negative trends, which may flow from abundance in resources and are not described under the Dutch Disease. For example, terms like 'the resource curse', 'petroleum state' or 'petropolitics' often emphasis a much larger impacts of resources on development of states. Next this essay will look at possible techniques of avoiding the Dutch Disease, outlining the existing models and success of their application. The second section will look at the former Soviet republics more specifically. It will outline the case of Kazakhstan, which is the richest in oil resources of all the former Soviet republics. Examining the initial conditions inherited by Kazakhstan and its transition year, this essay will examine to what extend could, and in fact did, the Dutch Disease affect Kazakhstan's development. It will emphasize the variation of post Soviet states from the models presented as possible 'victims' of the Dutch Disease, however, will not dismiss the possible negative effect of resources on their development. The essay will conclude with a short presentation of the solutions Kazakhstan adopted for mitigating the effect of resources on its development and their relative success.

The terms itself comes from the situation in Holland, which in the 1960s started developing its gas resources, but did not manage to improve it economic situation. The term Dutch Disease describes a situation in which countries find that having high income from development and export of natural resources (usually referred to oil and gas) corresponds negatively to their economic performance. This follows the logic that intensive export of resources will lead to appreciation of the currency and decrease incentive to produce other tradable good (e.g. non-resource related industrial production, agricultural products).[1] Appreciation of the currency for sectors like industry and agriculture means that it becomes more expensive to maintain production. Furthermore, non resource sectors are less profitable and will attract less investment, this in turn, leads to fall back of the above sectors. An additional danger for reliance on export of oil is the inherent volatility of natural resource prices.[2] If resource prices collapse, the damage done to other sectors of the economy might be detrimental for further development. However, there is still a debate about the extent to which the Dutch Disease has a deterministic affect on resource plenty economies. It seems that it is not only the direct impact of export of resources, which has a negative correlation to economic development, but there are important intervening factors. The political implications of high revenues from oil lead to a culture of rent seeking and distortion of institution, which in combinations with high relative prices (a direct impact of the Dutch Disease) create an unfavourable situation for economic development.[3] The simple explanation is that since revenues from resources are so high, corruption and rent seeking is only natural to follow. In productions such as industry or agriculture, the revenues are more likely to be distributed to wider sections of the population, at least since they require more work force, whereas the resource sector is more likely to become dominated by a small elite

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and is unlikely to incorporate wider parts of the population. In addition, the resource sector does not create many employment possibilities. These conditions are described in the literature as 'the resource curse'. Terms like Petroleum State also describe a situation when government revenues do not come from taxes from its citizens, hence breaking the accountability mechanism in the relationship between citizens and their elites in a modern state. However, the problems underlined by the 'resource curse' are structural and institutional ones, and by being so, can supposedly be overcome by good management of the resource revenues. Moreover, it points in the direction that there are circumstances under which the Dutch Disease and the 'resource curse' will not have real effects on economic and political development.

Models for mitigating 'the resource curse' usually come down to a debate on creation and different models of stabilisation and saving funds. The three main aims of resource funds are protect the economy from volatility of prices, to save for future generations and mitigate possible affects of the Dutch Disease.[4] The point is that for different aims, the government saves most or some of the revenues from exports of resources. Those who argue for the creation of stabilisation fund put forward successful cases like Norway's Government Petroleum Fund and the Alaskan Permanent Reserve fund, both are successful at creating large savings (Norway's is 82.2 billion USD) and are well managed. [5] However, those who argue to the contrary point out that successful funds are rare and that the success of the fund is dependent on its good management (features like guaranteed accountability and transparency). In order to achieve these conditions the government has to have good governance practices, which are likely to provide good basis for management of the revenues even in the absence of a saving fund.[6] Thus it has been argued that in countries where practices are not poor creation of a saving fund will only lead to waste and increase stealing. [7] Furthermore, poorer countries, which need acute investment in their infrastructure and poverty elevation, might find that saving revenues seriously is highly unpopular as well as objectively harmful.[8]

Looking at the developments in the former Soviet republics, some of the observations made by the literature definitely fit the empirical evidence, while others remain unimportant. In order to test the extent of the influence of resource revenues on the economic and political development of former Soviet republics one needs to look at the initial conditions they inherited from the Soviet past (i.e. the structure of their economy) and at the developments they went through in the early years of transition and see to what extent these were affected by the abundance of resources. Most of the natural resources in the post Soviet space are located in Russia's far east, Kazakhstan, Turkmenistan and Uzbekistan. Inner Caspian countries (i.e. Kazakhstan, Azerbaijan and Turkmenistan) have 96 percent of proven oil reserves in low case scenario and 71 percent of proven gas reserves.[9] Out of those Kazakhstan has the largest oil reserves (85 bb of which 10-16 bb proven) and extensive gas reserves (88 trillion cubic feet out of about 300 in total in the Caspian region).[10] Most of these countries experienced similar trends in the early 1990s, which included sharp falls in GDP and contraction of industrial production, which was followed by extensive exploration and development of reserves of natural resources.[11]

Kazakhstan, like other Central Asian countries, was developed up to Soviet standards and had a developed industrial sector, which included plants to produce iron, steel and rare metals.[12] Kazakhstan was also positioned well for foreign trade as it was one of the biggest exporters among Soviet republics.[13] One of the main problems it faced was lack of routs of transport, since all the main routs of transport and pipelines were directed through Russia. In early 1990s Kazakhstan went through a process of privatisation and liberalisation similar to the one experienced in Russia. In the same time its GDP fell by 55 percent between 1990 and 1995 and industrial production shrank by 56 percent.[14] Up to 1994 some democratisation and pluralism was practiced, but in later years the government was actively suppressing opposition and co-opting the rest of the elite. Ethnic strife and immigration of ethnic minorities (Russians and Germans) were another feature of the early transition year, when the population dropped from 17 million to 15 million people.[15] It is also important to note that the process of privatisation, which took place especially was accompanied by corruption and rent-seeking practices, especially in the phase starting in 1995, when privatisation was done through sales. This stage of privatisation coincided with large international interest in Kazakhstan and exploration of its oil reserves, which mainly took place in 1993-1994.[16] Sales were mainly done through powerful contacts and by 1997 caused some intra-elite battles. Foreign investors, on their side, quickly became disillusioned with the Kazakh bargains, which proved to be hard for extracting profit. Some examples are long negotiations and renegotiation, like in the case of Chevron in 1993 (Chevron lost the bid to Mobil) and operational difficulties like encountered by Tractebel in 1996-2000 (the company faced serious difficulties with

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running Amatyenergo and in 2000 it withdrew from the country).[17] This trend of selling assets was due to poor economic situation and from 1999, when Kazakhstan started enjoying from high oil prices, privatisation became almost a halt.[18]

Looking at Kazakhstan's initial conditions and the development of its political and economy it is hard to extrapolate direct causes of a Dutch Disease. The dynamics of former Soviet republics is of a transition rather than of countries that suffer from problems of rich plenty. Many of the setbacks which were experienced in Kazakhstan, for example, can be traced to other problems rather than to their reliance on exports of resources. First, there is an important argument that since the industrial output contracted before the major explorations of resources and high revenues from their exports, the country is unlikely to be a victim of the Dutch Disease. Meaning that it was not the appreciation of the currency that led to the dying out of other sectors, but the painful transition to market economy. Inefficient financial sector, corrupt bureaucracy and poor institutions, and limited protection of property rights, discouraged formation of new enterprises and restructuring of old ones.[19] On the political arena, suppression of opposition and lack of political reforms were a trend long before Kazakhstan started enjoying high revenues from resources. In fact, it has been noted by Rumer and Zhukov that Central Asian regimes resemble in many ways other non-democratic Asia regimes like Singapore, but in more authoritarian version.[20] Similar trends of degeneration of industrial and agricultural sectors and divergence from democratic practices can be seen in other former Soviet republics, which do not have large natural resources. Second, in Kazakhstan natural resources, neither in income to the budget nor in percentage in exports, reach the levels of countries, which are known to be affected by the Dutch Disease.[21] Although this argument might be limited, since Kazakhstan might have not reached the peak of its export of natural resources. Problems of transport mean that only a small amount of the natural resources are being exported, which presumably can change when circumstances allow it. Nevertheless, it is fair to claim that currently Kazakhstan's problems are not directly due to heavy reliance on exports of natural resources. Moreover, its management of the stabilisation and saving National Fund of the Republic of Kazakhstan (NFRK), created in 2000, so far seems to have positive resonance and functions well, although it is still in need to improve practices of transparency.

The impact of resources on Kazakhstan's and other CIS countries development is limited but it cannot be ignored, even if currently it is a mere trajectory of development. The Dutch Disease is unlikely to have a direct effect on countries where transitions were the main determining factor in the initial years, but it can have a serious effect on the direction of their future development. The possibility that resources will become a curse has not manifested itself in the 1990s, but the lack of incentive to restructure the industrial sector and lack of planning for the agricultural sector can be attributed to abundance in resources. For example, Kazakh government announcements for reform of industrial and agricultural sectors had little results so far. It is also unlikely that with increasing revenues from exports of natural resources that Kazakh political elite will break its cartel and allow new actors to enter the arena.

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[5] Kalyuzhnova Y. in *Comparative Economic Studies*, Vol. 48, (2006)

[6] Kalyuzhnova Y. in *Comparative Economic Studies*, Vol. 48, (2006)

[7] Khasanova M. in Rumer R. and Zhukov S. (ed.), (1998), P. 194

[8] Kalyuzhnova Y. in *Comparative Economic Studies*, Vol. 48, (2006) and Khasanova M. in Rumer R. and Zhukov S. (ed.), (1998), P. 194

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[9] Bilgin M. in Energy Policy, Vol. 35 (2007)

[10] Rashid A., (???), P.144

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[12] Rumer B. and Zhukov S. in Rumer B. and Zhukov S. (ed.), p.5

[13] Khasanova M. in Rumer R. and Zhukov S. (ed.), (1998), P. 173

[14] Rumer B. and Zhukov S. in Rumer B. and Zhukov S. (ed.), p.7

[15] Pomfret R. in Europe Asia Studies, Vol. 57, No.6, (2005)

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[17] Pomfret R. in Europe Asia Studies, Vol. 57, No.6, (2005)

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[19] Pomfret R. in Europe Asia Studies, Vol. 57, No.6, (2005)

[20] Rumer B. and Zhukov S. in Rumer B. and Zhukov S. (ed.), P.9

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