Research Note—Module 2
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IDV 880 Geopolitics of Oil

Research Questions: You work as an assistant to the Finance Minister of a small island nation, where recent oil and gas discoveries will make you a major exporter of LNG. Your minister recognizes the importance these funds play in paying for education, health and infrastructure, but wonders whether there are deleterious as have been seen in various countries. You are asked to write a memo, with reference to specific people and points of view (including your own) that does the following:

1) Outlines the possible deleterious Effects of this newfound wealth.

2) Highlights the major benefits of being a large LNG exporter.

3) Discusses concrete ways the government could maximize the benefits of all while mitigating the ill effects.

Outline

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Introduction

The discovery of natural resources, particularly of oil and gas, poses both significant positive prospects as well as negative opportunities. While it is tempting to relish in newfound wealth and engage in the world export market, the challenges that loom are anti-climactic if not mitigated with proper planning, policy, and governance. Background is offered within this note as to the deleterious effects of the oil and gas business of states as well as the benefits that can be realized and how to maximize those benefits. It is achievable to have a stable and prosperous government and society as a resource-rich state despite the many instances that point to the contrary. For, while there is a documented path that will lead to negative outcomes, having those documented lends to understanding how to deviate from that path. Forward-thinking policies that account for the short-term introduction of the new wealth into the economy and infrastructure as well as long-term sustainability are recommended.

Deleterious Effects of Newfound Wealth

Resource Curse

The "resource curse" refers to a documented paradox that exists in resource-rich countries, wherein economic growth does not necessarily occur as a result of natural wealth and, instead, the opposite effect is observed (Frankel, 2012). There has been a large body of research applied to understanding this apparent paradox out of which, many channels of causation have been identified, with a stand-out few that include: 1) Price volatility; 2) Autocratic institutions; 3) Rent-seeking; 4) permanent crowding out of manufacturing; and, 5) Dutch disease (Frankel, 2012).

Volatility in oil revenues and government policies responding to that volatility has been posited to be the true curse, not the oil resource itself. For example, in Iran the rapid expansion of

the oil industry could not keep up with demand lending to inflation. This revealed institutional weaknesses that led to the 1979 Revolution. The people were calling for reduced oil production so that other sectors could flourish. In Iran's 100 years since discovering oil, it is made clear that their economy is heavily oil-dependent and that volatility creates significant shocks to revenues. The Iranian Revolution was a significant event, serving as a demarcation in world history, wherein after the Revolution, global relations were forever impacted (Husain, 2003). The long-standing reign of autocracy and reign of a rich, military-backed Shah, was overthrown by a popular theocratic agenda put forth by Ayatollah Khomeini (Esposito, 2000). The Iranian Revolution came about as a result of the popular desire to return to self-sustainability, a fundamental aversion to participating in how the West does things and a perception that was the direction Iran was headed, and significant policy failures of the ruling Shah (Mohaddes & Pesaran, 2013). Similarly, evidence of the resource curse is present in the United Arab Emirates (UAE) who, despite their economic growth, is not demonstrably well-prepared with countercyclical measures. Evidence shows that the government has not been able to establish robust enough institutional mechanisms to counteract the effects of oil price volatility. This is a missed opportunity for UAE and points to an aspect of a resource curse (Soto & Haouas, 2012).

Non-democratic regime structures can be more desirable to oil-rich states because there is little incentive to become democratic (Hertog, 2011). Russia's economy bankrupted subsequent to the Cold War, for example, but it was the increased demand for oil that rapidly allowed for economic rebound placing them now squarely back in contention for power status on the world stage (ibid). Strong autocratic rule tends to lend itself better to both preserving the power achieved by oil rents, while also bolstering that power with significant investment in military (Ross, 2012). Autocratic governments have wealth, power, political influence (i.e., as part of OPEC and

price regulations), and typically do not apply taxation, thus are not accountable to their constituents (Frankel, 2012). But, research has shown that citizens show greater support for governments with lower taxes and larger budgets, thus reinforcing an autocratic structure (Ross, 2012). To become democratic would demand significant investment in institution-building (Soto & Haouas, 2012), which would cut into rents being realized, as well as potentially de-stabilize support for government during that shift opening up an opportunity for upsetting the balance of power (Ross, 2012). To support this argument, it is easy to look at trends for democracy outside oil-rich countries. The oil business took off in the 1970s (Mohaddes,& Pesaran, 2013; Soto & Haouas, 2012), which was also the starting point for the boom in shift to democracy (Ross, 2012). While today, most of the world is democratic, oil-rich countries primarily in the Arab world are not.

Rent-seeking is a revenue model that occurs without creating avenues for new wealth but relies on existing capacities. Rent-seeking, or a government's realization of revenues from the natural resource wealth, is a significant contributor to competitions for power that can lead to fractionalization (Bjorvatn, Farzanegan & Schneider, 2012). Such a practice occurs in states that are heavily oil-dependent economies. Rent-seeking reduces the government's responsibility because it does not then need to rely on taxation. Windfalls from oil generate rent-seeking behaviors that are linked to corruption and civil conflict (ibid). For example, resource misallocation and misuse of rents are directly observable in government wages and public employment sectors, pointing to another symptom of the resource curse (Soto & Haouas, 2012).

The "Dutch Disease" is a term that describes the phenomenon of the discovery of a natural resource weakening other sectors (Frankel, 2012). So, a rise in one weakens all others and that rise opens doors for corruption. The disease applies to discovery of resources that are finite placing economies in precarious positions. This applies less to countries with massive oil stores in terms

of sustainability but raises issues for growth and development (Mohaddes & Pesaran, 2013). While the term "Dutch Disease" originated when the phenomenon was observed during a short-lived discovery of gas in the Netherlands in the 1960s (ibid), the effect can be observed in other countries today. For example, oil represents 70% of total exports for UAE and 73% of government revenues. Due to significant population growth and importing of labor, over time, the average output per capita has decreased, lending to stagnation of productivity levels (Soto & Haouas, 2012). In essence, policies have been created to dampen innovation and technological efficiencies, thereby creating stagnation in other sectors besides oil. While the terminology may reduce the connotation of the Dutch Disease phenomenon, it is a significant issue because what countries may gain from the sale of oil can be counteracted by the reductions in other sectors and the resulting lack of diversification (Ross, 2012).

Stability Considerations

In addition to the economic 'curses' and 'diseases' associated with oil wealth, it is also important to note that conflict is a very real threat within an oil-dependent economy (Hertog, 2011). In fact, since 1990, oil-producing countries had more conflict than non-oil producing conflicts globally (Ross, 2010). Income and population are each significantly correlated with conflict onset. Oil has been shown to have a larger effect on the onset of conflict in lower income countries. Overall, findings show that oil producers are more likely than non-oil producers to have civil war, particularly post-Cold War and for low and middle income countries (ibid). In low-income states, oil can be attractive to rebels financially, moreso than life as a citizen (Ross, 2012).

Fractional governments often arise from the power struggles that result from anarchic behavior within resource-dependent countries. Research has demonstrated that a fractional

government realizes no benefit from resource revenues and are essentially wasted (Bjorvatn, Farzanegan, & Schneider, 2012). However, when governments are not fractional, there is a positive impact on income. Implications for countries undergoing significant political changes is that policies should be put into place to counteract the impacts of rent-seeking and fractionalization as well as strengthen institutions (ibid). In addition, in a study of five petroleum-rich states including Russia, Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan, it was shown that oil wealth lead to weakened state institutions when the government had a significant role in the industry (Ross, 2012).

Benefits of LNG Export

It has been demonstrated within the field of political economy that increases in a state's income per capita has direct impacts on improvements in political well-being, gender issues and political violence (Ross, 2012). Oil, while being criticized for being subject to the "resource curse," has been shown to be good for an economy when certain conditions are in place. For example, in the case of Iran, oil-wealth was found to be good for the Iranian economy as long as the government implemented better, more stabilizing policies to deal with price and revenue volatility (Mohaddes,& Pesaran, 2013). Oil is supported as a viable input to the Iranian economy because it is more the endogenous factors, primarily institutions and government, that make oil appear to be a curse rather than a blessing (ibid). Oil income has only been a problem in Iran when it comes to revenues and the government responses to volatility (ibid). Similarly, the UAE has seen significant growth and development, lending to a realization that it is possible to escape the curse. UAE gross domestic product has increased exponentially since the discovery of oil growing at a rate of over 5% each year, exceeding other resource-abundant economies. Oil in the UAE was

found in 1960s and ramped up in 1970s lending to significant development and increased income levels in the region (Soto, R. & Haouas, I., 2012).

Oil wealth creates an additional opportunity to become a self-sustaining economy with less reliance upon outside financing that can become additionally cyclical and reinforce dependency on loans, subsidies, and aid thus limiting development and growth opportunities. The Russian government leveraged its oil abundance to facilitate its recovery from the Cold War residuals. The government opted to utilize the oil revenues to halve its loans between 1998 and 2006 from $150 billion to $73 billion (Goldman, 2010). Over this period, those who invested in the oil and gas industry realized financial prosperity, and because much of the world's oil importers sought to be relieved of reliance on oil by the tumultuous Middle East, Russia was able to fill a need and take advantage of the opportunity (ibid).

Indeed, it raises questions about theories positing that resources provide significant barriers for growth and development as such a position cannot explain relatively stable regimes in oil-rich economies such as under Saddam Hussein, Indonesia's Suharto, and Saudi Arabia's royal family. While support is found for the assertion that oil abundance is significantly related to civil conflict, it is with caveat (Cotet & Tsui, 2010). The relationship between oil and conflict disappears when controlling for other factors, which implies that if policies are predicated on the assumption that oil breeds conflict, major decisions and efforts could be misallocated (ibid).

The one grave mistake some oil-wealthy countries have made, and could have both political and economic negative impacts, is to fail to properly plan for sustainable economic growth or equilibrium where it concerns their natural resources. Because resources are finite, learning from examples such as Norway, is advisable. Norway has been one of the world's largest exporters of oil and supplies much of Europe but reached their peak production in 2001. The impacts of

Norway running out of oil could have far-reaching consequences so forecasting their eventual decline is useful (Hook & Aleklett, 2008). Instead of being a negative input to the economy in Norway, oil revenues have been used to save and invest in human capital, development, social systems, and institution building (ibid). Such an approach can be of great long-term benefit to a state with newfound wealth in oil. Thus, while oil can be a finite resource, there is still an opportunity to plan for the future.

Benefit Maximization

Considerations

Newfound resource wealth brings with it both opportunity for benefits and negative consequences. What has been identified as a curse has also been a blessing for many and proper policy and nation-building can facilitate curse avoidance: "The Natural Resource Curse should not be interpreted as a rule that resource-rich countries are doomed to failure" (Frankel, 2012). Considerations for any country with newfound resource wealth, particularly oil and gas, should be around what portion of the revenues should be applied to the annual budget and what should go into savings for future application (Ross, 2012). Another consideration is how quickly money can be absorbed by the economy and the institutions supporting the economy, which without proper pacing could lend to overburdening of institutions and create avenues for abuse and corruption (ibid). Planning for the future generations is as important as planning for current economies so both short- and long-term planning is critical (Hook & Aleklett, 2008). Long-term strategies also help to address market volatility previously noted as a significant barrier to growth. As an example, volatility within Iran has outpaced the volatility of oil prices. Monetary funds have been established and over-turned and re-established through successive regimes as a means of addressing the volatility (Mohaddes

& Pesaran, 2013). Creating sustainable policies for such funds would be beneficial in Iran's instance and is an important consideration for other states. In addition, it is important that resource-rich developing countries diversify and add manufacturing rather than rely solely on resources. It has been found that for a 1% increase in income, demand for primary products decreases by less than 1%, suggesting that resources are a bad long term investment unless augmented by other diverse economic strategies (Frankel, 2012).

Recommendations

To maximize the benefits of resource wealth, investment, savings, institutional development, long-term strategies, and good governance are essential. Recommendations in these areas are as follows:

- **Investment in human capital:** In a study of UAE policies, it was determined that better economic growth could be realized with more effective investments in human capital to not only prevent productivity stagnation but to spark innovation (Soto, R. & Haouas, I., 2012). Long-term development cannot occur without infrastructure and public investment in areas like education and health (Ross, 2012). This recommendation may seem counter-intuitive that to realize growth, you must spend, but such a relationship has been well-documented.
- **Market integration:** While it could be tempting for a state to retreat into self-sufficiency and encapsulation with newfound wealth, such an approach has had significant drawbacks for oil-rich countries in the Arab world. Instead, noting Dubai's pro-business policies and model for de-regulation as well as world market integration can serve as a model to follow (Soto, R. & Haouas, I., 2012).

- **Plan for volatility:** As a result of market volatility with marked "booms" or huge influxes of revenues, governments fall prey to increasing spending proportionately with those cycles (Frankel, 2012). Planning for long-term savings despite the peaks and valleys of revenue from resources can provide for a more sustainable and stable economy.
- **Savings and investment:** "If oil-producing countries want future generations to benefit from today's resource extraction, they must invest an even larger fraction of their revenues than other countries" (Ross, 2012). This approach can appear severe, but has been an effective approach for Norway to plan for long-term benefits.
- **Government control:** When governments have control of the resource, proper long-term planning and governance is necessary to ensure economic sustainability (Frankel, 2012). Thus, when a country relies on a resource as their mainstay, there should be proper governance and planning. Privatization is one option.
- **Property rights:** It is difficult to enforce property rights to help to govern the sustainability of a resource. Offering incentives to restrain impinging on resource rights may help the efforts of state institutions (ibid).
- **Institutional development:** Resources have been found to negatively impact institutional development especially for "point source" resources such as oil, minerals, crops, coffee, and cocoa. Better developed institutions can better support major world shifts such as industrial revolution or globalization (ibid).
- **Stability:** Because a relationship has been established between dependence on oil/material wealth and civil war, governments should take proper steps to find balance to prevent de-stabilization (ibid). Strengthening military, reinforcing and establishing strong institutions, and offering visible growth opportunities for citizens are some sample strategies.

- **Diversification:** "Crowding out" refers to resource-rich countries focusing on their primary commodities and ignoring the manufacturing sector, which can be harmful to the economy. It is important to assess how to both benefit from comparative advantage as well as seed additional sector productivity.

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