IS FINANCE LIKE CRUDE OIL?

THE RESOURCE CURSE, OR THE PARADOX OF POVERTY FROM PLENTY.

feature

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Countries rich in minerals are often poverty-stricken, corrupt and violent. A relatively small rent-seeking elite captures vast wealth while the dominant sector crowds out the rest of the economy. The parallels with countries 'blessed' with large and powerful financial sectors are becoming too obvious to ignore.

While serving as the Reuters correspondent in oil-rich Angola in the mid 1990s, I wondered how such a 'rich' country could suffer such poverty. The shortest answer at the time was 'War'. Angola's conflict had many causes, but without the diamonds to fuel rebel leader Jonas Savimbi's army, not to mention the government's offshore oilfields, it would have been less bloody, and shorter.

As I arrived in Angola in 1993 a British academic, Richard Auty, was putting a name to a then poorly-understood phenomenon: what is now widely known as the 'Resource Curse'. Countries that depend heavily on natural resources like oil or diamonds often perform worse than their resource-poor peers in terms of human development, governance and long-term economic growth. Studies by renowned economists such as Jeffrey Sachs, Paul Collier, Terry Lynn Karl, Joseph Stiglitz and many others have now established the Resource Curse in the academic literature, and in the public mind too.

A weak version of this Curse, which few would disagree with, holds that resource-dependent countries tend to be bad at harnessing those resources to benefit their populations - as Figure 1 strongly suggests. The windfalls are squandered. A stronger version is more surprising: natural resources tend to make matters *even worse* than if they had been left in the ground, leading to higher rates of conflict, more corruption, steeper inequality, deeper absolute poverty, more authoritarian government, and lower long-term economic growth. I am in no doubt that the stronger version of the curse applied to Angola on all these metrics when I lived there.

To be fair, the wider cross-country evidence here is more complicated. Some countries like Norway that already have good governance in place before resources are discovered seem to fare relatively well – but being rich first is no guarantee of success either. Michael Edwardes, the former chairman of ailing British car manufacturer British Leyland, spoke of this with some prescience in 1980, following the OPEC oil price shocks: "If the cabinet does not have the wit and imagination to reconcile our industrial needs with the fact of North Sea oil, they would do better to leave the bloody stuff in the ground." Even if some rich countries can suffer from mineral windfalls, it is poor, badly governed countries that tend to suffer the most. The picture also varies with the global commodity price cycles: things look particularly bad during troughs in these cycles – as in the mid 1990s – and look less bad, at least on the surface, in the boom years.

How do we explain this 'curse?' The explanations fall into three main categories. First is the so-called "Dutch Disease." Large export revenues from oil, say, cause the real exchange rate to appreciate: that is, either the local currency gets stronger against other currencies, or local price levels rise, or both. Either way, this makes local manufactures or agriculture more expensive in foreign-currency terms, and so they lose competitiveness, and wither. Much higher salaries in the dominant sector also suck the best skills and talent out of other sectors, out of government, and out of civil society, to the detriment of all. Overall, the booming natural resource sector 'crowds out' these other sectors, as happened when many oil producers saw devastating falls in agricultural output during the 1970s oil price booms.

Finance-dependent economies, it turns out, suffer a rather similar Dutch Disease-like phenomenon, as large financial services export revenues in places like the United Kingdom or the tax haven of Jersey raise the cost of housing, of hiring educated professionals, and the general cost of living. A Bank for International Settlements (BIS) study last year found that finance-dependent economies tend to grow more slowly over time than more balanced ones, and noted that, by way of partial explanation, 'finance literally bids rocket scientists away from the satellite industry'. My short *Finance Curse*

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e-book, co-authored with John Christensen, provides plenty of detail on this.

A second standard explanation for the Resource Curse is revenue volatility. Booms and busts in world commodity prices and revenues can destabilise the economies of countries that depend on them, further worsening the crowding-out of alternative sectors. Gyrations in the world oil price – from below $10/barrel in the late 1990s to well over $100 within 10 years – has played havoc with budgeting in many oil-dependent countries, often with terrible effects on economic and political stability and broad governance. Those alternative sectors that were crowded-out during the booms aren't easily rebuilt when the bust comes: it is a ratchet effect. Again, there are close parallels with the financial sector, a source of great volatility, as the latest global financial crisis shows. Britain's industrial base, decimated by (among many other things) over-dependence on the financial sector, is proving slow to recover, post-boom.

The third category for explaining the Resource Curse – the biggest, most problematic, and the most complex – falls under the headline 'governance'.

Why do natural resources tend to make governments more wasteful, corrupt, and authoritarian?

A big part of the answer lies in the fact that minerals in the ground provide unproductive economic 'rents': easy, unearned money. As the Polish writer Ryszard Kapuscinski so brilliantly put it:

Oil is a resource that anaesthetises thought, blurs vision, corrupts. Oil is a fairy tale and, like every fairy tale, it is a bit of a lie. It does not replace thinking or wisdom.

When easy rents are available, rulers lose interest in the difficult challenges of state-building, or the need for a skilled, educated workforce, and instead spend their energies competing with each other for access to a slice of the mineral 'cake'. While those neglected sectors wither, this competition among 'godfathers' can lead to overt conflict, particularly in ethnically diverse societies, but it can also lead to great corruption, as each player or faction in a government knows that if it does not act fast to snaffle a particular mineral-sourced financial flow, another faction will. This is the recipe for an unseemly, corrupting scramble.

The financial sector, likewise, contains a multitude of potential sources of easy 'rents'. A secrecy law, for instance, has long been a source of rents for Swiss bankers, who haven't needed to do much else apart from watch the money roll in. More grandly, the network of British-linked secrecy jurisdictions scattered around the world, serving as 'feeders' for all kinds of questionable and dirty money into the City of London, is another big source of rents for the financial sector. Financial players' special access to information is another. Martin Berkeley, a former British banker, described one mechanism deployed by his bank as it sought to sell its customers dodgy derivatives:

On their client database they had in big letters written 'Client Has Screens' - meaning the client actually knows what the markets are doing: these tricks couldn't be played on them.

The Libor scandal provides another example of rent-seeking. One might reasonably also make a comparison between owning an oil well and having – as the banking system does – the ability to create money. Yet there is a difference too: rising credit creation – and the growing private debts that accompany it – generate fees for the financial sector that are extracted not from under the ground, as with oil, but from debtors, taxpayers and others: from the population itself.

Another source of the trouble in resource-rich states is that when rulers have easy rents available, they don't need their citizens so much to raise tax revenues. This top-down flow of money undermines the 'no taxation without representation' bargain that has underpinned the rise of modern, accountable states through the rise of a social contract based on bargaining around tax, and through the role that tax-gathering plays in stimulating the construction of effective state institutions. If the citizens complain, those resource rents pay for the armed force necessary to keep a lid on protests.

In economies dependent on finance we don't see the same kind of crude, swaggering petro-authoritarianism of Vladimir Putin's Russia or José Eduardo dos Santos' Angola, but we do see some surprisingly repressive responses to criticisms of the financial sector and the finance-dominated establishment, particularly in small tax havens like Jersey, as Mike Dun's article in this edition – along with the main *Finance Curse* e-book and my book *Treasure Islands* – repeatedly illustrate.

All these processes – the economic crowding-out of alternative economic sectors such as agriculture or tourism, plus the 'capture' of rulers and government by the dominant mineral sector, who become apathetic to the challenges posed by trying to stimulate other sectors – add up to a mortal threat not just to democracy, but also to the long-term prospects for a vibrant economy. Since Angola's long civil war ended 11 years ago, politicians have routinely called for a 'diversification' of the economy and a 'rebalancing' away from dependence on oil. The fact that petroleum still makes up over 97 percent of exports and contributes to 60 percent of GDP, is testament to the difficulty even the most well-meaning reformer faces. Similarly, calls for 'rebalancing' away from excessive dependence on the financial sector have tumbled from the mouths of politicians in the United Kingdom and Jersey. But these calls will prove equally empty if they do not actively work to shrink and contain the financial sector.

Nicholas Shaxson is author of Poisoned Wells, *a book about the resource curse in oil-rich countries in Africa, and of* Treasure Islands, *a book about financial centres and tax havens.*