Resource Curse and Economic Diversification

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Economic diversification is an essential aspect of sustainable development as diversification enhances macroeconomic stability and promotes structural and long-term transformation not only in the economy but also in other pillars of development such as social institutions and dimensions.

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1. Introduction

The resource curse, also called resource trap or the paradox of plenty, is a concept indicating a paradoxical phenomenon in which a country with an abundance of valuable natural resources underperforms economically. Countries become vulnerable to falls in natural resource prices and thus to long-run economic underperformance when they fail to make adequate investments in non-resource sectors, particularly manufacturing. The resource curse and blessing, or the antagonistic and complementary relationship between natural resource abundance and economic development, has been broadly examined in the literature. Studies show that it causes a substantial nominal, and also a real, appreciation in the currency if the currency has a floating exchange rate, and that it reduces exports in non-resource sectors because of short-term high and relatively easy earnings in the resource sectors [1]. For instance, Angola, the second-largest oil exporter in Sub-Saharan Africa after Nigeria, has experienced exchange rate pressure and dollarization and an increase in oil shares over the total exports—thus a decrease in non-resource exports [2]. The literature also reported that the economic structures of many countries have been adversely affected by resource abundance in the long term, although only a few have benefited from it [3]. In line with the solid empirical findings in the literature such as Ahmadow 2014 [4], a promising potential solution for ending the resource curse is to diversify away from primary commodities into new sectors and industries by actively promoting citizens into productive work and entrepreneurial activities [5][6]. In order to avoid the resource curse, economies are advised to generate income from different sources that are not dependent on a sole resource such as oil and natural gas. In this regard, economies are expected to move to a more diverse production form by obtaining or developing the know-how required to manufacture high-value-added products and provide services. The literature demonstrates that economic diversification and structural transformation are correlated with economic growth, particularly at initial development stages [7][8], indicating that resources are reallocated dynamically to technology/knowledge-based productive businesses, industries, and sectors through simultaneous structural transformation and diversification.

Despite the consensus on the importance of diversification for economic and overall sustainable development, there is a limited understanding of the specific factors driving economic diversification, particularly in the context of resource-rich economies, so that accurate, reliable, and repeatable diversification strategies can be designed with minimal ambiguities. Ploeg (2011) investigated various hypotheses in his seminal work for the positive and negative impacts of extracting natural resources for export purposes on the economies of resource-rich countries [9]. He reported that countries depending on primary exports of natural resources illustrate lower growth rates and higher income inequality, particularly if the rule of law, the quality of institutions, and corruption levels are wide and deep in the society. That study emphasizes the importance of quality institutions, trade openness, and R&D investment in technology exploration for rentier states to enjoy natural resource wealth benefits. However, resource-rich countries present different and distinctive patterns regarding their economic, social, and cultural structures to cope with the diversification challenges. Alsharif et al. (2017) survey the history of the success and failure of diversification and conclude that the Middle East and North African (MENA) countries and those in the Sub-Saharan African belt lack sufficient policies and regulations to encourage diversification away from resource-based economies [10]. Frequently fluctuating energy commodity prices exert pressure on energy-rich countries and stimulate their policymakers to give importance and priority to economic diversification. Indeed, oil-rich countries are supposedly in an advantageous situation to develop sustainable, competitive, and innovative sources of economic growth because they hold significant capital due to resource rent which can be invested in diversification, but they have not achieved it yet although it has been in their strategy agenda for many decades [11].

2. History

The importance of economic diversification is widely acknowledged around the world, and many resource-abundant countries have been striving to make and implement diversification policies to improve their economic performance and achieve a sustainable economy [11]. Economic diversification, which is an essential aspect of the development process for not only rentier states but all countries, improves macroeconomic steadiness and resilience to financial shocks and supports a transition to sustainable and higher growth [8]. The lack of economic diversification and specializing in resource exports could crowd out other tradable sectors, which would ultimately have negative externalities on the economy. IMF (2014) [7] surveyed the progress and policies supporting economic diversification in the Gulf Cooperation Council (GCC) countries and documented that macroeconomic stability, improving the business climate, promoting trade and FDI, advancing education, and diversifying the industrial base and service sectors are among the factors directly related to economic diversification performance [12]. The literature accommodates many studies focusing on only a few of these factors to evaluate their link with economic diversification. Harding & Javorcik (2011) focus on FDI [13], Aker and Aghaei (2019) [14] on the business environment, Olander (2019) [15] focuses on institutional quality, and Matallah (2020) [16] on the relationship between governance indicators and economic diversification.

The factors driving economic diversification require more investigations comprehensively in a multifaceted perspective, although researchers have spent tremendous time and efforts linking diversification and economic development. Many empirical studies have focused on export diversification, which is a byproduct of economic diversification. Most of these works aim at identifying the impact of export diversification on economies [17][18][19][20]. Ahmadov (2014) conducted empirical studies to estimate the effects of economic and structural variables on export concentration by employing panel data of 65 developing countries having resource rents higher than a certain threshold [4]. He concluded that diversification is considerably limited in countries with authoritarian institutions, fragile law and regulations, and arid and torrid terrains such as the Middle East and sub-Saharan Africa. His study reported that political participation and quality of government surprisingly do not have an impact on export concentration, whereas he found weak evidence supporting the effect of trade integration and policy, as well as tariff rates, on export concentration.

Parteka and Tamberi (2008) investigated the effects of various variables—country size, geographical conditions, endowments, human capital, and institutional setting—on export diversification employing panel data for 60 countries and showed that country size and closeness to major markets are statistically significant determinants for export diversification [21]. Similarly, Agosin et al. (2011) illustrated that increases in trade openness cause human capital growth and larger specialization, and thus increases in export diversification, while financial development has a limited impact on it [22]. Ross (2019) analyzed economic diversification among the 38 largest oil-producing countries for the 1962–2010 period and found that an increase in diversification leads to a decrease in oil wealth [23]. He also demonstrated that diversification success is weakly associated with government performance, population, and democratic accountability. Addisu et al. (2020) defined country-level “competitive capability” as helping the evaluation of non-resource-based growth by associating it with non-resource growth rate [24]. This descriptive study evaluates the performance of diversification and development of these capabilities assessing correlations among variables. It presents evidence of the positive associations between competitive capabilities and resource abundance.

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