

ISRAEL REAPPROVES THE CREATION OF A SOVEREIGN WEALTH FUND TO PREVENT 'DUTCH DISEASE'

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What does it mean?

In economics, the Dutch disease is the apparent relationship between the increase in the exploitation of natural resources and the decline in the manufacturing sector (as defined by Wikipedia). Generally, an increase in export revenues from natural resources will strengthen the country's currency resulting in a decrease in the attractiveness of other non-energy industry exports. In other terms, it is the phenomenon whereby an increase in commodity exports following a resource boom drives up the value of a country's currency resulting in a decline in the country's overall industrial and manufacturing sector.

Who said it first?

The term was coined by The Economist in 1977 to describe the decline of the manufacturing sector in the Netherlands after the discovery of a large natural gas field in 1959:

'[...] in the words of Lord Kahn [1905-1989], 'when the flow of North Sea oil and gas begins to diminish, about the turn of the [21st] century, our island will become desolate.' Any disease which threatens that kind of apocalypse deserves close attention.' 'The Dutch Disease,' The Economist, November 26, 1977: pp-82-83.

In the 1960s, the Netherlands' new found gas deposits led to an increase in revenues. While the Dutch Guilder gained in strength, Netherlands' non-energy exports suffered as they became too expensive for other countries to buy.

How does it work?

In a 1982 paper by W.M. Corden and J. Peter Neary, the authors explain that a booming export sector raises the countries income as more foreign exchange flows into the local economy. If all the money going in the country was spent on imports, the equation would remain unaltered. However, if it is converted in local currency and spent on domestic nontraded goods like it is often the case, the result will depend on whether the country's exchange rate is fixed or flexible. If it is fixed, the conversion of the foreign currency into local currency would increase the money supply in the market, increasing domestic demand, leading to an increase in domestic prices. If

the exchange rate is flexible, the increased supply of foreign exchange would strengthen the domestic currency. In both cases the real effective exchange rate relative to other countries, rises, weakening the competitiveness of the country's export industry (leading to a reduction in the GDP growth rate). It might be argued that it is not that much of a disease as long as the new revenues are expected to be permanent or in other terms, if the new found wealth will last in time and remain dedicated in part to export. However, even the second scenario would be detrimental to the economy because other industries will shut down and jobs will be lost.

How to prevent it?

When new wealth is expected to generate abundant revenues, policymakers must intervene in advance to prevent the occurrence of the malady and protect the overall economy. Offshore gas reserves have recently been discovered in the Eastern Mediterranean basin: Cyprus and Lebanon are in the process of developing their offshore reserves. According to *Reuters*, Israel, who is ahead in the gas race compared to its neighbors (Israel's gas started flowing from its Tamar field last month; production from the Leviathan is expected between 2015 and 2017), reapproved Sunday the creation of a sovereign wealth fund to prevent a steep appreciation of the Shekel once natural gas fields start to generate high levels of income. Sterilizing the boom revenues by bringing them slowly to the economy and saving them in special funds is an effective method to prevent the sudden strengthening of the local currency. This measure has the advantage of also creating a stable revenue stream.

Awareness is paramount

The Eastern Mediterranean countries, long considered energy-poor, might be home to huge untapped offshore hydrocarbon reserves that could boost their economies and turn them into net gas exporters should the geopolitical challenges be overcome. The new wealth will start flowing into the country when the gas flows out and the focus should be on the economy. It is not too early to stress on the importance of an effective administration of revenues. The awareness of the risk of 'Dutch Disease' is paramount for preliminary preventive measures to be adopted. After all, '*A great fortune in the hands of a fool is a great misfortune.*' (Unknown source).