Dutch Disease and Policy Adjustments to the Oil Boom: 
A Comparative Study of Indonesia and Mexico*

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Abstract

The oil price hikes of the 1970s resulted in a large income transfer to oil-exporting countries. While the windfall gains of the oil boom should have worked in favor of economic development, it was observed that the oil boom brought about adverse side-effects termed the ‘dutch disease,’ which refers to the negative effects that an export boom may have on traditional export sectors (tradable sectors) in many oil-exporting countries. In the light of the subsequent contraction of the tradable sector, we suspect that an export boom is a mixed blessing to developing countries, because they have to drive the development process through the expansion of tradable sectors. Indonesia and Mexico provide an interesting contrast with regard to economic performance during the oil boom; while the former succeeded in expanding her non-oil export base rapidly, the latter experienced a steady stagnation of the tradable sector. In this paper, we attempt a comparison between Indonesia and Mexico in their policy adjustments to the oil boom, especially in their fiscal, foreign borrowing, and exchange rate policies.

The major findings can be summarized briefly: (1) While Mexico adopted a highly expansionary fiscal policy aimed at rapid development, Indonesia deliberately accumulated budget surpluses under the guise of ‘balanced budget principle’ with delicate operations: the Indonesian government wisely avoided the expansionary effects potentially to be brought about by the abundant oil revenues. This difference suggests that Indonesia succeeded in sterilizing a part of the oil bonanza, while the Mexican government spent all of the oil revenues indiscriminately, and, still more, accelerated its spending by heavy foreign borrowing. (2) As for the composition of the government expenditure, we have found that Indonesian budget expenditure was more balanced and went largely into the non-oil tradable sector, while Mexican expenditure was strongly biased toward investment in the oil sector. This contrast implies that Indonesia used its oil revenues to strengthen the production base of the tradable sector such as agriculture and manufacturing which could have been possibly damaged by the dutch disease.
typical case can be found in its agricultural policies. (3) In foreign borrowing, there existed a marked contrast. Mexico accumulated its external debts, especially short-term debts, with the need to finance the current account deficits which were largely attributable to fiscal expansion, and capital flight. By contrast, Indonesia maintained a conservative stance on its foreign borrowing strategy. (4) Both countries devalued their currencies during the oil boom. While Mexico failed to sustain the devaluation effect due to inappropriate economic management, Indonesia succeeded in maintaining the effect with appropriate demand management policies such as building up of budget surpluses.

The conclusion following from these findings is that Indonesia, unlike Mexico, responded to the oil boom in a manner consistent with the policy adjustments which are required to avoid the dutch disease. Our comparison confirms the conventional understanding that a booming government should be conservative, as was the case in Indonesia, in its macroeconomic management to avoid the dutch disease. Equally significant, investment use of oil revenues to strengthen the tradable sector is another factor responsible for Indonesian success. These factors, we have found, are reinforced and promoted in Indonesia by two economic crises before and during the oil boom, i.e., the economic collapse under the Sukarno regime in the mid 1960s and the ‘Pertamina Crisis’ in 1975, via improving the relative position of the economic technocrats to the economic nationalists in the policy making process.

References


*A full paper and related articles by the author will be provided to researchers upon request.