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## Does EITI prevent the natural resource curse in financial development?

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► **To cite this version:**

Harouna Kinda, Edouard Mien. Does EITI prevent the natural resource curse in financial development?. 2024. hal-04746325v1

**HAL Id: hal-04746325**

**<https://hal.science/hal-04746325v1>**

Submitted on 21 Oct 2024 (v1), last revised 13 Dec 2024 (v2)

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## Focus on research

# Does EITI prevent the natural resource curse in financial development?

*L'ITIE empêche-t-elle la malédiction des ressources naturelles dans le développement financier ?*

Published on April 25th, 2024. [Read the blog article.](#)

The mismanagement of natural resources can compromise the efficiency of factors essential to economic development, commonly called the "resource curse". In addition to worsening the socio-economic situation, dependence on natural resources can hinder the emergence of an efficient financial system in countries with weak institutions. Conversely, good management of natural resources can enable low- and middle-income countries to improve their economic performance. We first describe the theoretical mechanisms underlying the existence of such a "resource curse" and then present empirical evidence of the potential mitigating effect fostered by implementing the [Extractive Industries Transparency Initiative \(EITI\)](#) standard.

### How can natural resources hinder financial development?

This study focuses on some main mechanisms by which natural resources can hinder financial development. To begin with, natural wealth is often linked to poor institutional quality and an unfavorable business climate, which encourages corruption, political instability, and rent-seeking behavior. This undermines the credibility of public authorities and deters private domestic and foreign investors, hindering the development of the financial sector.

Furthermore, according to the Dutch disease, revenues from extractive resources stimulate domestic demand for foreign goods, generating inflation and an appreciation of the real exchange rate. The result is a loss of competitiveness in non-resource activities, notably manufacturing, which can harm the domestic financial sector (resource curse). Finally, the high volatility of commodity prices increases the volatility of export earnings and, consequently, the economy's vulnerability to external shocks, which increases uncertainty, discourages investment, and hampers financial development.

Natural resources tend to weaken the financial sector, even if the channels through which this happens are not always ideally identified. Yet the quality of natural resource institutions and management seems to be a key factor in explaining whether such a curse is likely to occur.

### How can EITI prevent the "financial resource curse"?

A classic response to improving the management of natural resources to promote positive spin-offs is to promote transparency and accountability in the resource sector, as encouraged by the EITI initiative. EITI is an international initiative designed to promote transparency and accountability in natural resource management by bringing together governments, private resource companies, and civil society representatives. The main idea is that implementing this initiative, which encourages greater transparency in natural resources management, can contribute to better utilization and thus mitigate the financial resource curse.

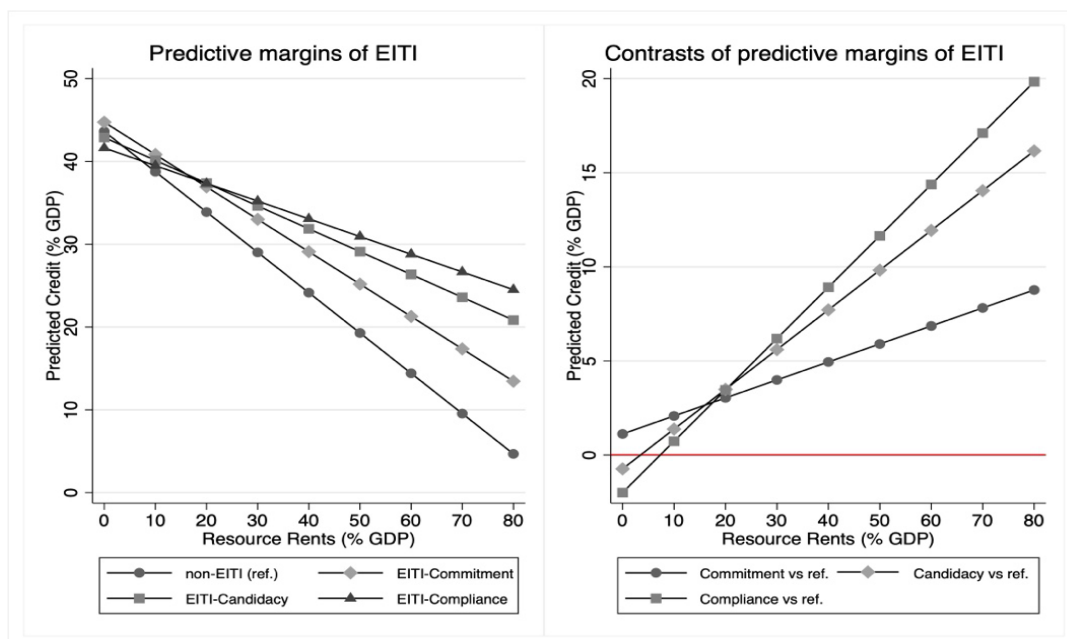
At first glance, the "public debate" model, which enables collective deliberation and collaboration between government representatives, private sector agents, and civil society organizations, means that EITI implementation promotes the sound management of natural resources and encourages adequate public investment. In this case, it will contribute to the credibility of public policies and the development of a good business climate, encouraging investment and national savings and thus contributing to financial growth. In addition, this dialogue between local communities, companies, governments, and civil society organizations could also help ease socio-political tensions caused by natural resource extraction by restoring the confidence of financial and private agents. The EITI requires countries to publish information on the entire extractive industry value chain, from the conditions under which extraction rights are granted to how revenues reach the government and benefit the population. Improved transparency reduces corruption and rent-seeking, which in turn helps mobilize public revenues from natural resources and reduces dependence on external debt. Countries can establish sovereign wealth funds to diversify reserve portfolios, generate higher returns and combat "Dutch disease".

Consequently, EITI implementation can play a crucial role in mitigating the various mechanisms by which a resource curse can occur, by encouraging practical improvements in public policies (resource governance, investment strategy...) and restoring the confidence of private agents. In this study, we do not seek to distinguish between these different mechanisms but only to analyze the knock-on effects of EITI membership in mitigating the consequences of the resource curse on the financial sector.

### **The effects of EITI on the financial curse of natural resources**

We study the effects of EITI membership on financial sector development in a panel of 71 resource-rich countries between 1995 and 2019, including 30 EITI adherent countries and 41 non-EITI countries. We applied both canonical fixed- and random-effects models and the entropy balancing specification, a matching approach allowing us to avoid potential endogeneity issues arising from selection bias. The results suggest strong evidence that natural resources increase the "natural resource curse" in financial development and that implementing EITI standards helps mitigate this curse.

Figure 1 reveals that while EITI membership is associated with lower financial sector development for low levels of natural resources compared to non-EITI members, this effect tends to diminish as resource rents increase until it becomes positive. These advantages become evident when a typical country relies on resource rents for around 15% of its GDP.



**Fig. 1.** Effect of EITI membership on domestic credit to the private sector (%GDP) at different levels of natural resource rents.

In a typical country with a 20% dependency on natural resource rents, the realized impact on financial development is a 3-percentage point increase in credit to the private sector (as a % of GDP) compared to a non-EITI member country for each stage of EITI implementation. At 80% dependence (which is the extreme value in our sample achieved only by East Timor in 2015), the positive effect is an 8-9 percentage point increase in private sector credit for committed countries (countries that have committed to the EITI but whose compliance with all requirements has not yet been validated) and a 20-percentage point increase for compliant countries (countries whose compliance with all EITI requirement criteria has been validated) compared with non-EITI countries.

Overall, these results indicate that (i) the EITI is helping to mitigate the resource curse on the financial sector, and (ii) each additional step in EITI implementation reinforces this mitigating effect.

### Concluding remarks

Transparency through EITI implementation can help mitigate the negative impact of natural resources on the financial sector of member countries. This result confirms that the EITI, while not a silver bullet, represents an effective policy program to mitigate the financial resource curse. This study informs the EITI Board, National Committees, and governments of the EITI's significant role in combating the resource curse.

However, it should be noted that the impact of EITI membership on mitigation is only partial, suggesting that transparency is a necessary but insufficient step in ensuring that natural resources can benefit economic development.



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**Article reference:** Kinda, H., & Mien, E. (2024). [Does transparency pay? Natural resources, financial development and the extractive industries transparency initiative \(EITI\)](#). *World Development*, 179, 106603.

**Keywords:** financial development; resource curse; natural resources; transparency.