Take a walk on the supply side

Tim Harcourt*
Chief Economist
Australian Trade Commission
Sydney
www.austrade.gov.au/economistscorner

The global economy is going gangbusters. Thanks to strong growth in the emerging economies – especially China and India – the world economy is in its best shape since the 1970s. And it's no longer reliant on the usual engines of growth – the USA, Europe and the G7 – to move along at a cracking pace. For instance, according to the IMF and the World Bank, East Asia is expected to account for two-fifths of world growth this year, which is expected to remain in the 5 per cent range well into 2008.

As a result, Australia is experiencing a commodity boom – that in many circles could shape up to be 'the rush that never ended' that economic historian Geoffrey Blainey famously wrote about occurring in the Australian colonies in the nineteenth century. In this new 21st century, there's constant talk of a super-cycle, or at least a very long boom and Australia's resource endowments and our proximity to Asia has put us in the right place at the right time. To use another famous Blainey phrase, the 'tyranny of distance' may well have been replaced by the 'power of proximity'.

As a result of the resources boom and Australia's role in it, our export values are at record levels. However, it is another matter with regards to change in export volumes (that is growth in the *quantity* of exports, abstracting for changes in prices). Even in the mighty resources sector, export volumes have been growing only at 2.2 per cent in the 2000s compared to over 7 per cent in the 1990s. This trend has been documented by many economists including John Edwards, Chief Economist at HSBC in a recent paper for CEDA's 'Competing from Australia' project. The Reserve Bank too, has highlighted the relative flatness of export volumes in its official statements.

So why is there a divergence between export values and export volumes in this decade? One reason has been the unanticipated strength of demand and the resulting boom in prices. In addition, there is the 'hard act to follow' argument. Some commentators believe that as the first 'post-reform' decade, the 1990s have been a hard act to follow in terms of export volumes. The economic reforms of the 1980s – floating the dollar, reducing tariffs, opening up the economy and associated changes – took a long time to work their way through so it is no surprise that you get a growth spurt in the next decade which sets a difficult benchmark to live up to in the subsequent decade immediately after.

Other economists believe that given the strength of demand in the world economy, that we must 'take a walk on the supply side' to get the bottom of the volumes story.

This is especially so as the Australian economy gets closer to full capacity and full employment of resources.

The most prominent 'capacity constraints' on the supply side, have of course been infrastructure 'bottlenecks' in rail, port and road and related logistics. One reason for this theory being so popular is that we can 'see' the bottlenecks physically. Newspaper photographs of ships lining up along the coast near the port of Newcastle are a classic example of bottlenecks. However, there are other (less visible) capacity constraints – for example, according to the DHL Export Barometer, manufacturing capacity - the lack of available plant, space and capital – in the manufacturing sector has been a major issue despite strong demand for Australian manufactured goods worldwide. In addition, we can also look to the labour market for other supply-side constraints. With Australia experiencing a low 4.4 per cent unemployment rate – the lowest it has been in three decades – exporters, like all employers, are experiencing labour shortages across all sectors. This is good news for some workers. Think of all those tradespersons who can attract top dollar wages in the mines in the north west of Western Australia.

The supply side issues, of course, have been coupled with a strong exchange rate. With the Aussie dollar now over the US 80 cents range a lot of exporters have been feeling the pinch in terms of competitiveness. However, the DHL Export Barometer has consistently found that whilst the exchange rate has affected prices and squeezed profit margins, there has not been a substantial effect on output or the decision to export or expand investment. Some economists have also warned that Australia might experience a 'Gregory effect' (named after legendary ANU economist Bob Gregory) whereby a high exchange rate triggered from a resources boom harms competitiveness in the import-competing manufacturing sector. However, when Gregory devised his thesis (also known as "Dutch disease" after a similar scenario occurred in the Netherlands after an oil boom) during the resources boom of the 1970s, few manufacturers and services companies were exporters, and the exchange rate was fixed, so the whole economy adjusted (instead of just the dollar). Furthermore, intra-industry trade was less pronounced then, unlike in today's economy where 45 per cent of exporters are also importers.

However, the experience of the 1970s has been raised in the context of the resources sector itself. Treasury economist David Gruen has looked at both resources booms and found that export volumes were also slow to pick up in the 1970s and the Reserve Bank agrees. According to the Bank's recent Statement on Monetary Policy: "…resource export growth has been broadly comparable to the corresponding stage of the mining boom in the late 1970s and early 1980s. On that occasion, mining investment rose for six years, but it took a further one to two years after the peak in investment before there was a significant growth in resource export volumes. In the current boom, mining investment has increased for five consecutive years, with increase in mine capacity and transport infrastructure expected to result in a significant lift in aggregate resource exports over the next tow years – in particular metal ores, metals, coal and oil."

But how does it affect the exporters themselves? One resource exporter put it this way "… I don't really look at export values or volumes – that is for economists. This important thing is that I am getting paid – and at the moment, we have never had it so good." Is this view representative of all mining exporters? The DHL Export Barometer consistently shows strong optimism in the mining sector, but with a floating exchange rate, we can always do more to improve things on the labour side. Investment in infrastructure, education and training as well as scouting the world for future opportunities and improving market access can always help out our exporters no matter how long the resources boom lasts.

**Tim Harcourt is Chief Economist of the Australian Trade Commission and the author of the new book BEYOND OUR SHORES www.austrade.gov.au/economistscorner).*

Thankyou to John Edwards and David Gruen for comments and assistance with this article.

Investment in the resources sector has been strong in response to high commodity prices