Balancing the Risks:
Building Australia's Economic Resilience

December 2005

Foreword

The Australian economy is undergoing a rapid transformation as unusually strong global forces are unleashed around us.

Over the past months Ai Group has embarked on a number of studies to assist in understanding these transformations and in developing appropriate policy responses to them.

Balancing the Risks: Building Australia's Economic Resilience examines the increased competitive confrontation faced by Australia's non-booming tradeable sectors. These sectors are doubly challenged by the emergence of more intense global competition and the commodity price fuelled exchange rate. *Balancing the Risks* undertakes a detailed analysis of the shifting trade fortunes of Australian manufacturers in particular.

Both the extent of the commodity boom and the prospect of a slow unwinding of existing global imbalances suggest that the Australian currency may remain at high levels for an extended period. ***Balancing the Risks*** raises the need to manage the risks surrounding this scenario.

It points to strategies underway in the manufacturing sector (the subject of an upcoming Ai Group report *Manufacturing Futures)* and suggests there is also a role for more active policy in the management of this risk.

Heather Ridout
Chief Executive

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Executive Summary

The Australian economy is undergoing rapid adjustments amidst unusual global circumstances. It is exposed to distinct risks. Much will rest on how the economy responds to these adjustments and how it manages these risks.

At the global level we are witnessing the rapid accumulation of productive potential in a number of emerging economies and most notably in China. Commodity prices are at unusual highs and significant global imbalances are evident.

Closer to home the commodity-price related jump up in the exchange rate is adversely affecting domestic producers in non-booming tradeable sectors. In addition, manufacturers in particular are affected by the strong competitive challenges coming from Chinese and ASEAN producers. The examination of Australia's trade in manufactured goods included in this paper finds that the challenges are being felt both in the domestic market and in the hard-won export markets developed over the past two decades.

Australian manufacturers have suffered a loss of market share three times greater than the OECD as a whole. We show that this additional loss of market share is well explained by the rise in the domestic currency.

Neither of these exposures seems to be going away. The emerging economies are clearly here to stay and there are strong risks that upward pressures on the domestic exchange rate will persist. This is supported by the slow adjustment to international imbalances anticipated by Ben Bernanke, chair elect of the US's Federal Reserve Board.

Effective management of the risks presented by these circumstances raises important questions both for individual producers and for policy makers.

Individual Australian producers are responding very actively to the risks surrounding the higher currency and the shifts in global production. Manufacturers, for instance, are embarking on a new round of productivity initiatives. This embraces reducing costs; outsourcing; investing – both domestically and internationally; restructuring; re-training their workforces and increasing expenditure on innovation. As we show, some manufacturing industries have been able to generate export growth in the face of difficult conditions.

The extent and pace of adjustment in the economy in the face of the current pressures and, more generally, in the context of Australia's relatively volatile exchange rate, poses questions for the role of policy in the adjustment process.

One role of policy makers is to make sure market adjustments are transmitted swiftly and effectively. At the most general level policy can support a stable macroeconomic environment and competitive levels of taxation. It can also support an effective and low-cost regulatory environment and take an active role in the planning, funding and coordination of infrastructure investments. While Australia has made good progress in many of these areas, there are still important steps to take.

If policy did take a more active approach what could it do sensibly to manage this particular risk? Policy is not good at picking winners but even if this approach is put on hold, there remain important roles for policy makers to play in balancing risk and in building Australia's economic resilience.

In Ai Group's view, a key direction for direct industry policy is the facilitation of industrial adaptation. In addition to the more general policy roles mentioned above, this should include:

- Investing in skill creation and development and in ensuring adaptability among training providers;
- Stimulating innovation through, for example, greater investment in and adoption of new industrial research; and
- Building better business capabilities including in the important area of exporting.

Part A. The Global Setting

The challenges facing Australia are, as ever, strongly conditioned by global forces.

(1) The Rise and Rise of the BRICs

Global economic developments are increasingly shaped by the continued rise of the BRICs (Brazil, the Russian Federation, India and China). Though they share little in common beyond large populations and recent fast growth, the BRICs have attracted close attention due to their present importance in key areas (Brazilian and Russian mineral resources, Indian services and Chinese manufacturing) and their likely emergence as major economic powers. Collectively the BRICs now account for 9_ per cent of market-valued global output (China's 4.6 per cent is the major contributor).

Continuation of fast growth will see the BRICs' share of global production rise dramatically in coming decades.

The investment bank Goldman Sachs estimates (on productivity and demographic trends) the BRICs to expand from their present size equivalent to one seventh of the G6 economies (US, Japan, Germany, UK, France and Italy) to one third by 2016; to a half by 2024 and to equality by 2039.

China has already gone past Italy, France and the UK this decade to move into fourth place on the league table of nations. It is expected to go past Germany in 2007, Japan in 2016 and the US in 2041. India moves to third place (behind the US and China) by 2032. Perhaps as telling from a growth orientation:

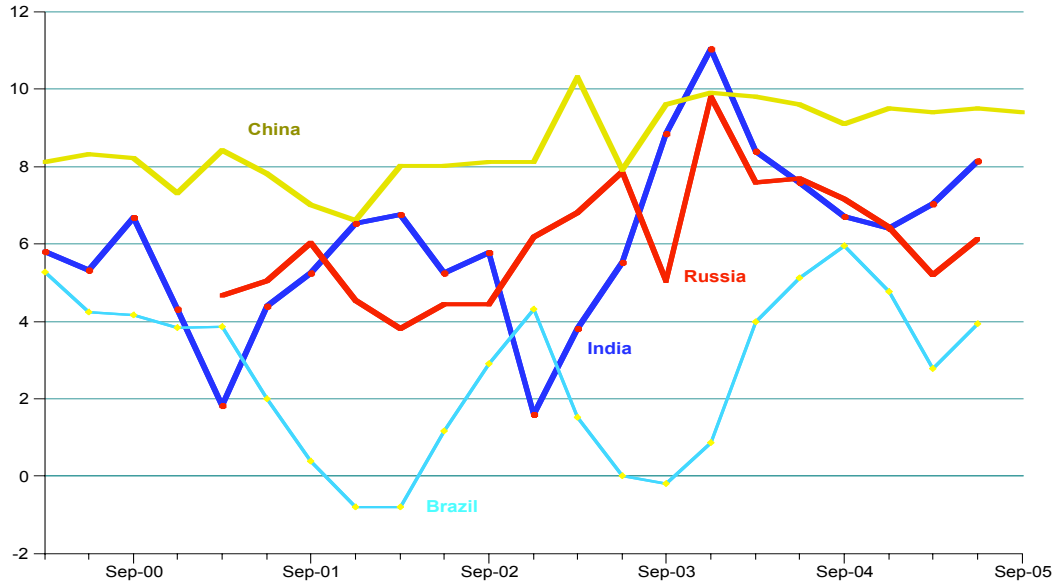
> *as early as 2009 the annual increase in US dollar spending from the BRICs could be greater than that from the G6 and more than twice as much as it [was in 2003]. By 2025 the annual increase in spending…could be twice that of the G6, and four times higher by 2050.*[1]

As a result, imports into the BRICs have been growing strongly, though perhaps not as quickly in all cases as would happen if currencies were allowed to appreciate. Over the year to the June quarter, import volumes to the Russian Federation grew 18 per cent and 12_ per cent to Brazil. Only nominal data are presently available for the other two, but non-oil import values (in US dollars) into India grew 34 per cent over the year to the September quarter while the corresponding growth for China was 15_ per cent in the quarter ending August.[2]

[1] Dominic Wilson and Roopa Parushothaman, "Dreaming with BRICs: the Path to 2050", Goldman Sachs, October 2003.

[2] The latter figure was depressed by an inventory correction early in the annual comparison, and it is expected growth rates will climb back above the 25 per cent mark now that the correction has finished.

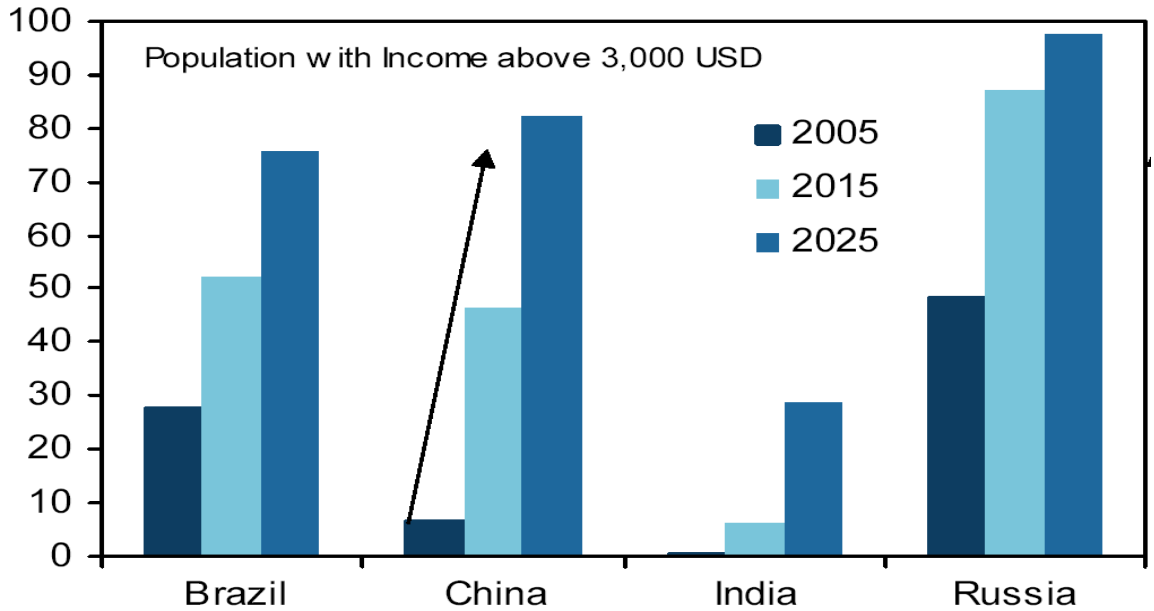
Chart 1
ANNUAL GDP GROWTH



Sources: OECD, CEIC.

One question posed by rapid growth in the BRICs illustrated in Chart 1 is the speed and extent of the spread of consumer durable and other purchases characteristic of middle classes in affluent economies. Recent projections by the Goldman Sachs research team are instructive. They look first to shares in population with incomes above $US3,000 per head, noting this to be the "point at which demand for many consumer durables starts to take off". Russia and Brazil are currently best placed (Chart 2), with only minor slices of Chinese and Indian society so favoured.

Chart 2
EMERGING MIDDLE CLASSES



Source: "Where are the BRICs consumers?", Goldman Sachs, July 2005. Data are percentages of population with annual incomes above $US3,000.

Along with further growth in Russia and Brazil, the Chinese share is expected to grow rapidly in the next decade with much of its population currently only slightly below the threshold. By contrast, "India is much poorer and even strong growth will not build a middle-class anytime soon". Further up the income scale only Russia is well placed to see large proportions above $US15,000 a year. Even by 2050, shares in Brazil and China are not projected to be far from 10 per cent with India scarcely registering. Nevertheless, the Goldman Sachs team notes some specific results from growing Chinese affluence.

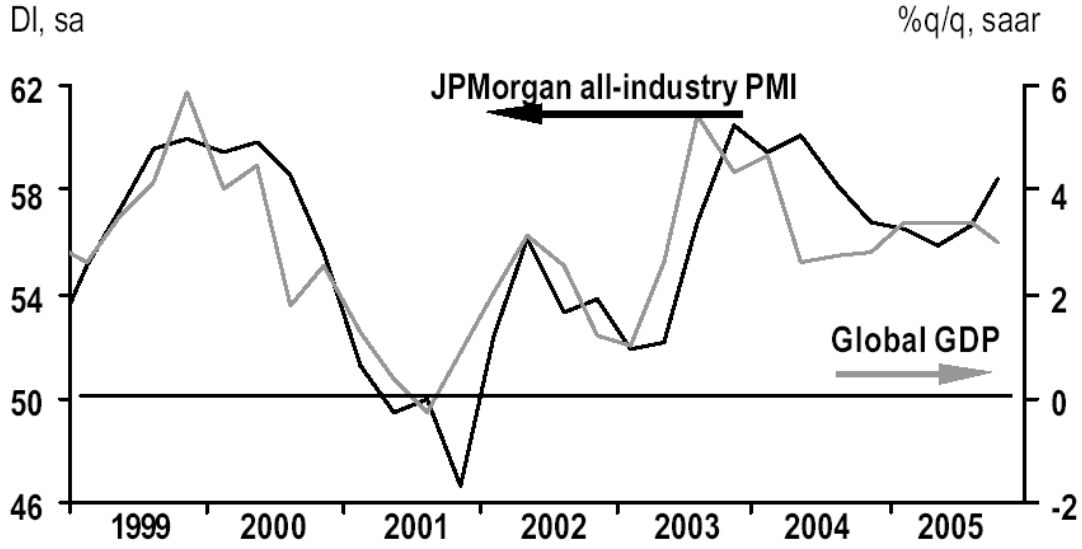
By 2015 China's share of the global "luxury goods" market is expected to rival that of Japan (a large 29 per cent each), while overseas tourism by Chinese should double that of Japanese by 2008.

(2) Global Growth in the Medium Term

While these fundamentals are a firm portent of substantial longer-term growth they are far from a guarantee of a favourable medium-term outlook.

With good assistance from the BRICs the global economy continues to post solid growth modestly above its potential rate (around 3_ per cent). The latest October global aggregate of national business assessments of trading conditions (Chart 3) is consistent with GDP growth around the 4 per cent mark.

Chart 3
GLOBAL ACTIVITY GROWTH



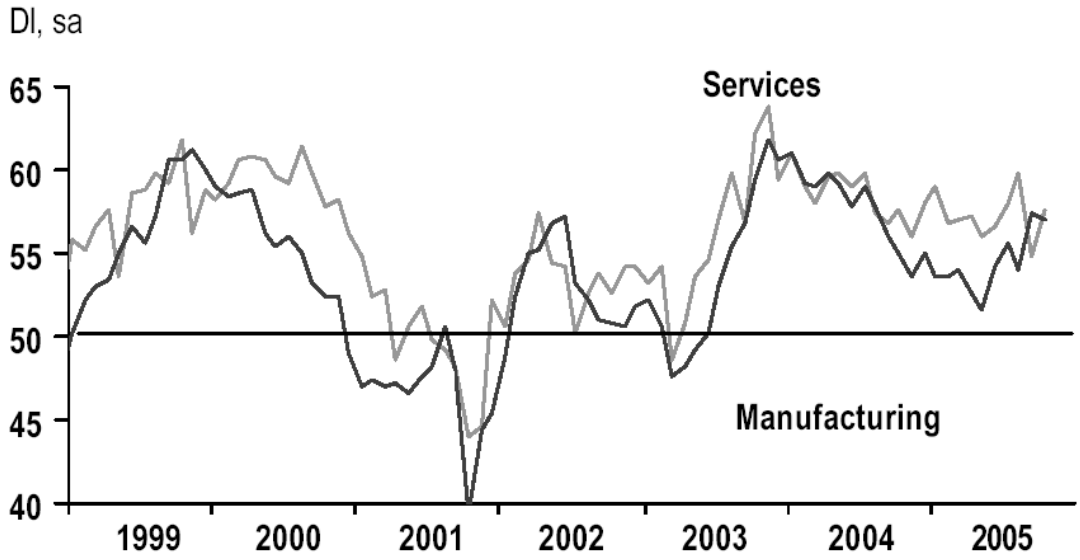
Source: JPM Global All-Industry PMI Survey: October 2005, November 3 2005. Data aggregated from national sources by J.P. Morgan.

A recent broadening of the base of the upturn is particularly encouraging.

- The recovery of new orders (Chart 4) suggests that global manufacturing has overcome its inventory indigestion of late 2004 and early this year. (Non-manufacturing has been firm throughout.)

- There has also been a geographic widening, seen especially in a Japanese domestic sector finally breaking free of the shackled state it had endured for more than a decade. Western Europe remains weak, but even there a response to global growth is evident, especially in Germany.

Chart 4
GLOBAL NEW ORDERS

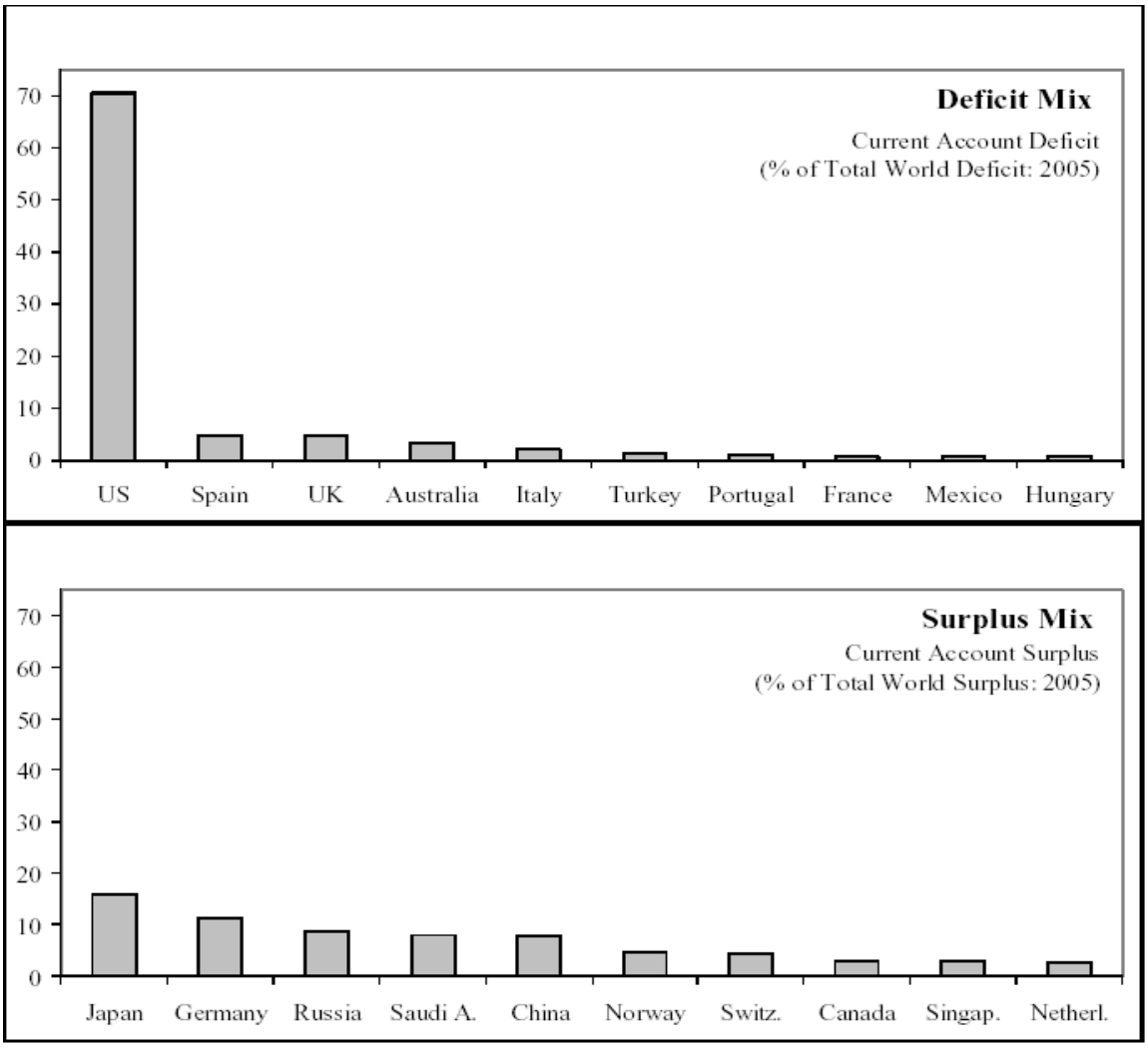


Source: JPM Global All-Industry PMI Survey: October 2005, November 3 2005. Data aggregated from national sources by J.P. Morgan.

(3) Global Imbalances and the Bernanke Doctrine

While these data suggest that medium term global growth prospects look sound, there is significant disquiet over the unbalanced nature of global progress in some quarters. After all, on IMF estimates of this year's outcomes the United States accounts for 70 per cent of all global deficits. The US deficit requires a capital inflow the equivalent of the combined total of the ten largest surplus countries to balance its current account outflows (Chart 5).

Chart 5
GLOBAL CURRENT ACCOUNT IMBALANCES



Source: IMF via Stephen Roach, Morgan Stanley.

A conventional view

Though the US need for capital inflow has been met to date (overwhelmingly through borrowing), one influential strand of global opinion sees this pattern as ultimately unsustainable.

- Any drying up of capital inflows to the US would be likely to generate a sequence of events that would narrow its spending growth opportunities.
- Thus a shortfall of capital inflow would trigger depreciation of the greenback, some lift in imported inflation and a likely rise in US interest rates.
- Some form of financial crisis would be possible if some highly leveraged players get into difficulties.

The solution, according to many global imbalance worrywarts, is for the US to take unilateral action to put its house in order, most notably by reducing its budget deficit and by taking steps to improve private saving.

This is a conventional view shaped by those who see current account developments being driven primarily through trading patterns. The US has simply been growing its spending too quickly for too long, and must soon slow down to accord with the average pace of its trading partners.

The Bernanke view

Ben Bernanke, the chair-elect of the Federal Reserve Board advanced a different view earlier this year. Essentially he sees global imbalances being driven by capital rather than trade flows.

- The Bernanke doctrine starts from saving gluts in parts of the world, most notably East Asia, that are not being put to use in their own economies.[3]
- The surplus funds are then invested elsewhere, by both public and private players, to obtain a return.
- This is the source of the capital inflow to the US, sustaining both an export-constraining level of the greenback and an import-promoting low level of interest rates.
- Though not intended as such, the recycling of funds from surplus to deficit countries represents a gigantic form of vendor finance for importing economies.

Bernanke sees the imbalances persisting as long as saving gluts persist. While corrections are ultimately necessary, unilateral contractionary action by the US would make a minor dent in its external deficit and would not remove the main global imbalances. The main outcome, according to Bernanke, would be reduced global growth as US spending subsided without offsetting increases elsewhere.

The "solution" to the global imbalance will arise as surplus countries allow their excess saving to be removed. This can occur through currency appreciation, which promotes additional importing and checks exports, or by autonomous domestic spending expansions. As and when these changes occur, market conditions for the present deficit countries will improve offering the prospect of currency-stabilising capital inflows being replaced by improved trade outcomes.

In short the present high degree of global imbalance need not be a precipitous slippery dip to economic crisis. While some signs of stronger domestic spending are emerging in the surplus countries (especially Japan), the adjustment is expected to take many years yet.

This perspective suggests a steadier correction of imbalances than some commentators appear to anticipate. To borrow a phrase from Australia's housing correction – we may be in for a soft landing. Importantly, this gentler pace of correction also suggests a more extended period of exchange rate disequilibrium than might otherwise occur.

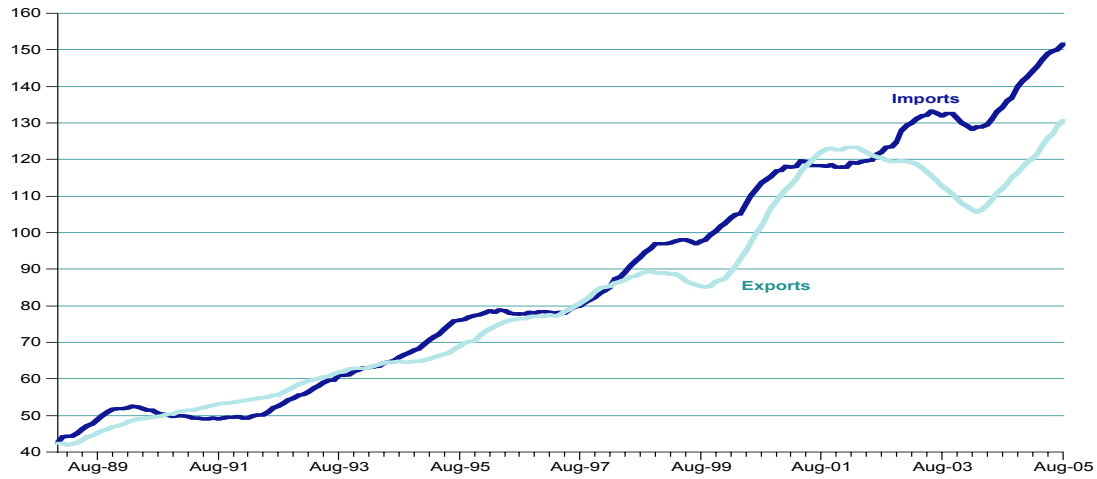
[3] Excess saving is simply another name for a current account surplus, since they are two sides of the same coin in the national income accounting identities. The new mercantilism of continuing external surplus practised by East Asian economies is seen partly as a natural defensive reaction to the currency vulnerability exposed by the late 1990s financial crisis. It is also a reflection of more cautious business investment throughout the region. The problem is not with household saving which has not increased relative to incomes; rather, private investment is more circumspect than in previous expansions.

Part B. Australia's Share of Global Markets

(1) Export Competitiveness

Australia's export competitiveness has slipped markedly over the last three years. Notwithstanding vastly improved commodity prices the overall merchandise trade balance, in surplus as recently as the year to June 2002, is now in heavy deficit (Chart 6).

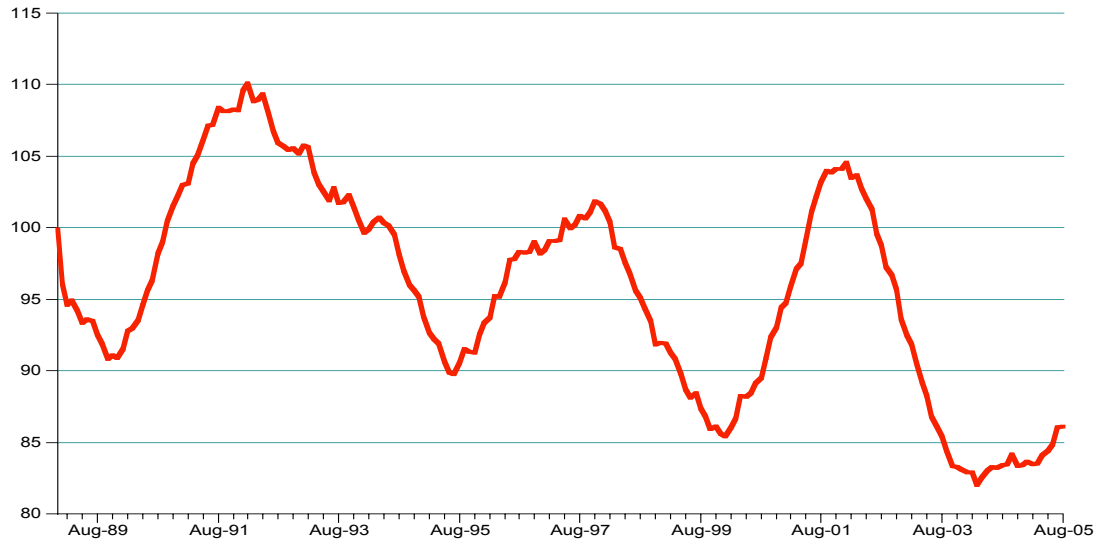
Chart 6
MOVING ANNUAL MERCHANDISE TRADE VALUES



Source: ABS cat 5432, 5439. Data are in billions of dollars.

The ratio of merchandise exports to merchandise imports is close to its lowest since the present data series started in the late 1980s (Chart 7).

Chart 7
RATIO OF MERCHANDISE EXPORTS TO IMPORTS

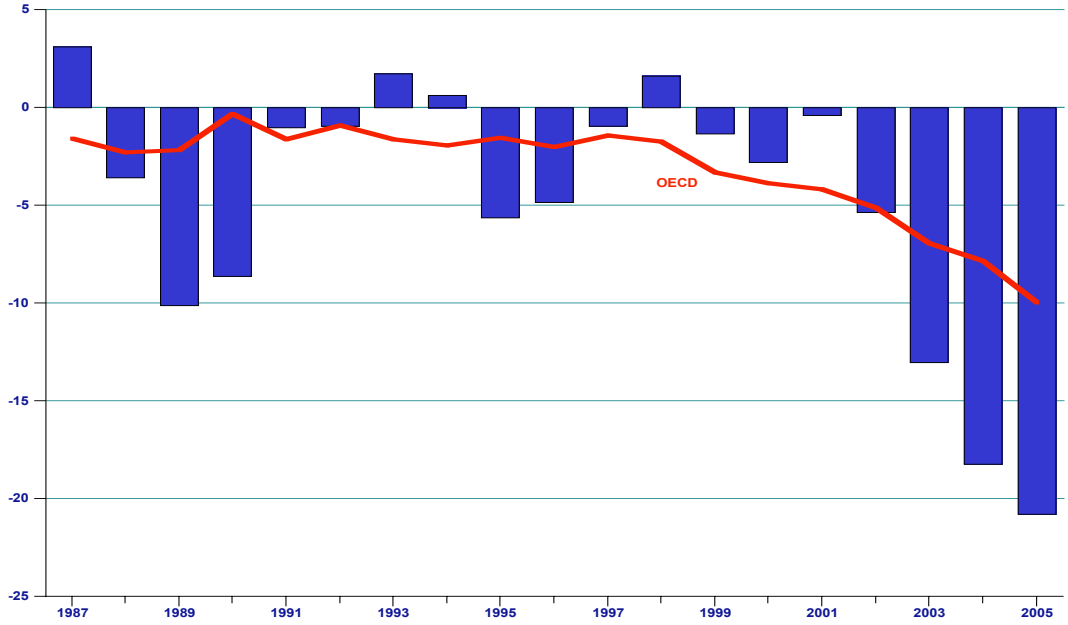


Source: ABS cat 5432, 5439. Data are moving annual totals of exports as % of imports.

The recent small uptick in the export ratio is due to huge rises in this year's bulk minerals contract prices. Even so the latest ratio remains approximately the same as the worst performance in previous downturns.

Chart 8
GOODS AND SERVICES EXPORT PERFORMANCE

Cumulative % change in market share since 1986: Australia and the OECD



Source: OECD Economic Outlook, June 2005, Annex Table 44.

For the decade to 2001 Australia's exports broadly maintained market share (although there were important changes in composition). In the four years since then Australian exporters have lost an estimated fifth of their previous market share (chart 8).

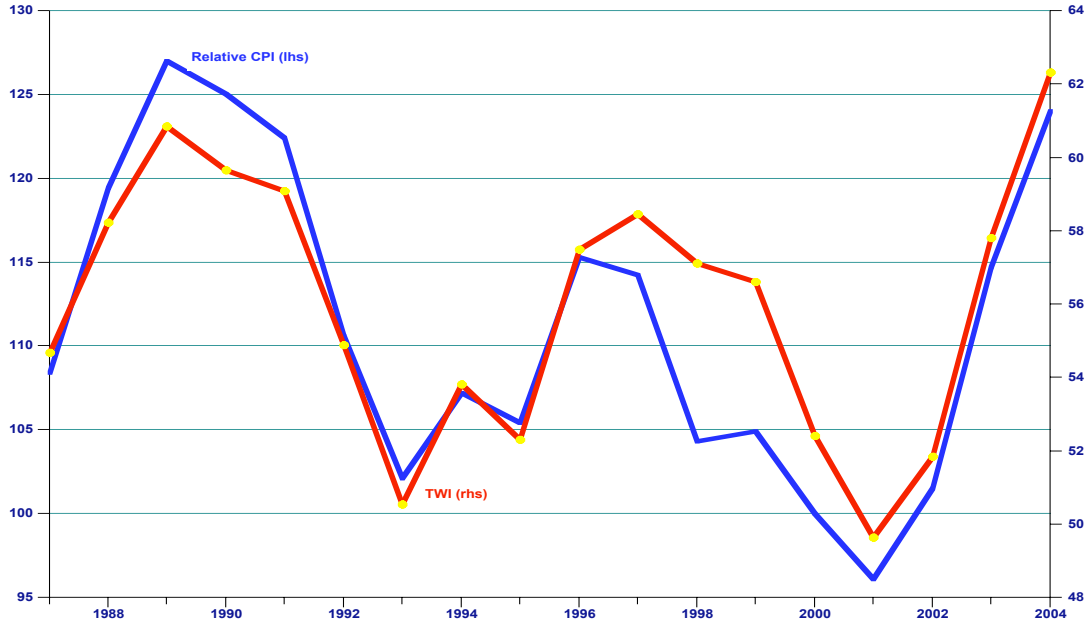
This declining market share has been a common experience for industrialised OECD economies as emerging producers (especially China) make their marks. Thus over the same four years, the average OECD economy has lost market share to the tune of nearly 6 percentage points. Australia has fared significantly worse than the typical OECD country.

Australia appears to have lost more than three times the average loss of market share of OECD countries.

Undoubtedly the additional factor at work in Australia's case has been the decline in competitiveness as a result of the currency appreciation. Chart 9, again using OECD data in its trade-weighted form, shows the steep rise of the Australian dollar against the Trade Weighted Index (TWI). This measure goes hand in glove with the OECD measure of international competitiveness based on relative consumer price index outcomes.[4]

[4] A rise in the relative CPI line implies decreased trading competitiveness.

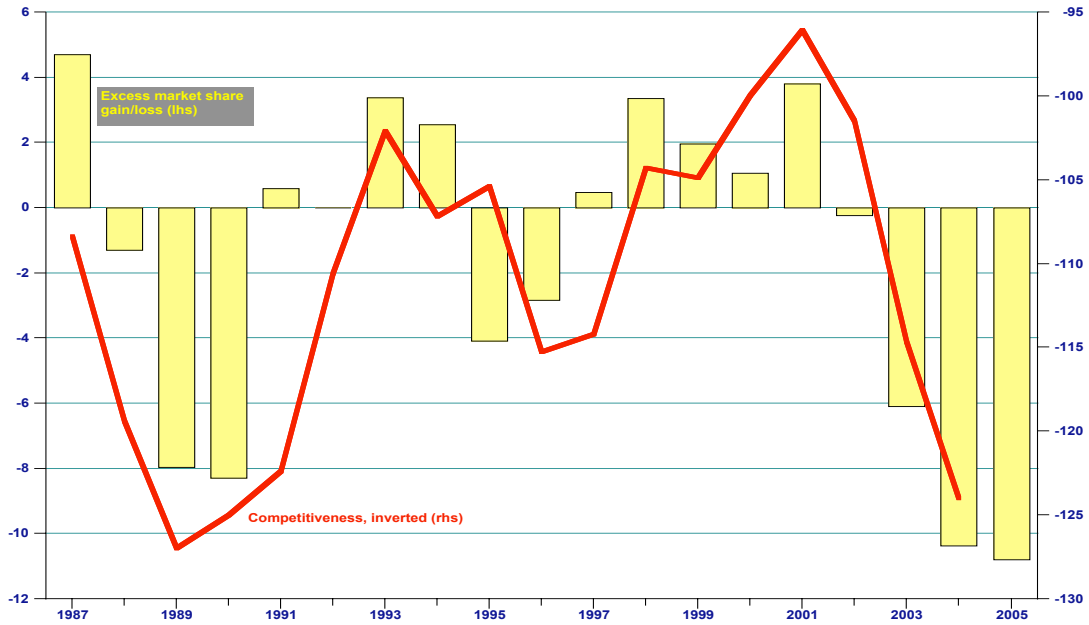
Chart 9
COMPETITIVENESS AND THE EXCHANGE RATE



Source: OECD Economic Outlook, June 2005, Annex Table 42, ABS.

The strong impact of currency movements on export market performance is illustrated in the next chart (Chart 10). In this chart the market share data from Chart 8 are used to indicate whether Australia is doing better or worse than the average OECD economy.[5]

Chart 10
CPI COMPETITIVENESS AND "EXCESS" EXPORT MARKET SHARE GAINS



Source: As previous. "Excess" market share is Australian minus OECD outcome of Chart 8.

[5] The average OECD market share performance has been subtracted from its Australian counterpart to provide an "excess gain or loss".

A positive figure in Chart 10 means Australia is doing better than the OECD average. The measure of "excess" is lined up against consumer price competitiveness from Chart 9 (inverted so that lower positions mean poor competitiveness).

The correlation is very strong. Much of the variation in market share is associated with competitiveness fluctuations, themselves heavily driven by the currency.

This analysis of OECD data supports the argument of an earlier Ai Group report[6] that the two Cs of currency and China are the key drivers of Australia's fluctuating export performance.

[6] Ai Group, *Who's Winning? The shape of global competition,* April 2005.

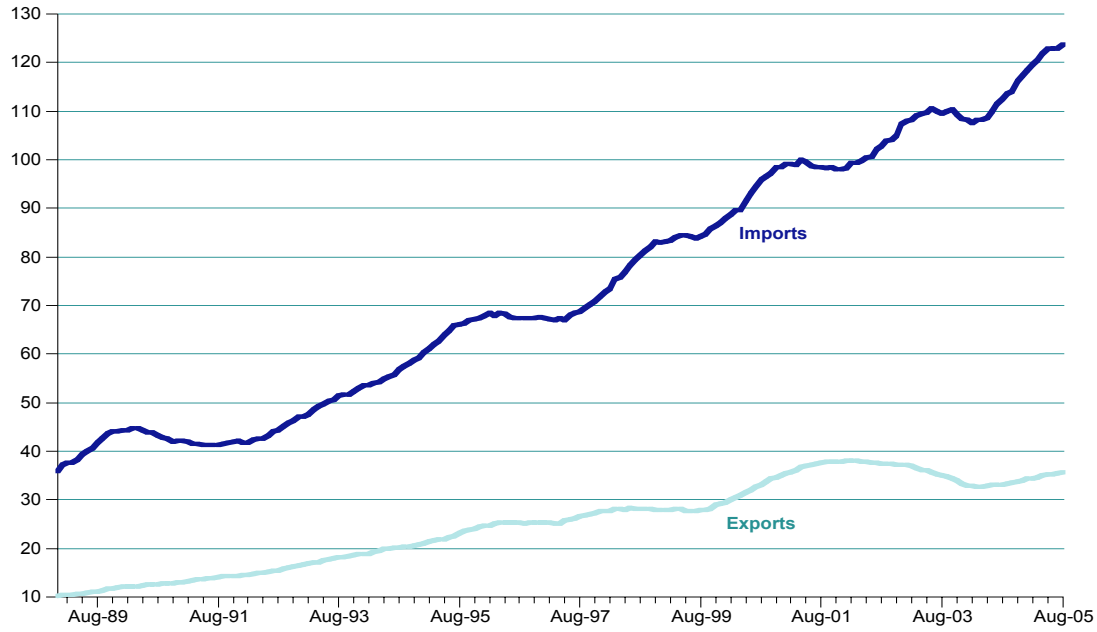
2) Manufacturing Trade Outcomes

2 a) Manufacturing Aggregates

This poor performance is reflected in outcomes for manufactured goods (Chart 11).

- The traditional large gap between export receipts and import payments for the sector has widened noticeably as export proceeds fell absolutely.[7]
- Though there has been a minor recovery lately, export receipts in the 12 months to August remain $2.3 billion (or 6.1 per cent) beneath their level in the year to March 2002.
- Meanwhile the manufactures import bill has continued to rise.

Chart 11
MOVING ANNUAL MANUFACTURING TRADE VALUES

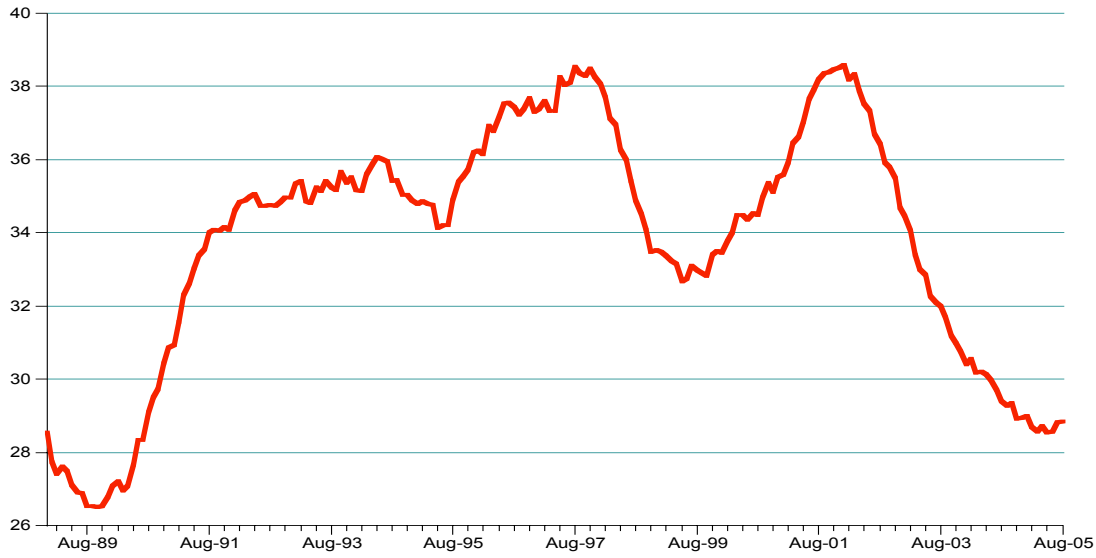


Source: ABS cat 5432, 5439. Data are for SITC 5,6,7 and 8 and are in billions of dollars.

[7] Export revenue proceeds have been affected by the rise of the Australian dollar. While nominal revenues over the year to June 2005 from ETM exports (categories 5, 7 and 8) remain 5.5 per cent lower than in 2001, volumes are estimated to have risen 7.9 per cent in the interim.

Seen from a different perspective nearly all the progress made in improving local manufacturing's market share has been wiped out. The ratio of manufactured exports to the manufactures import bill in the 12 months to August was back to levels last seen in mid-1990 (Chart 12). The ratio has plunged nearly 10 percentage points since January 2002 (from 38.6 to 28.8 per cent).

Chart 12
EXPORTS AS % OF IMPORTS: MANUFACTURES

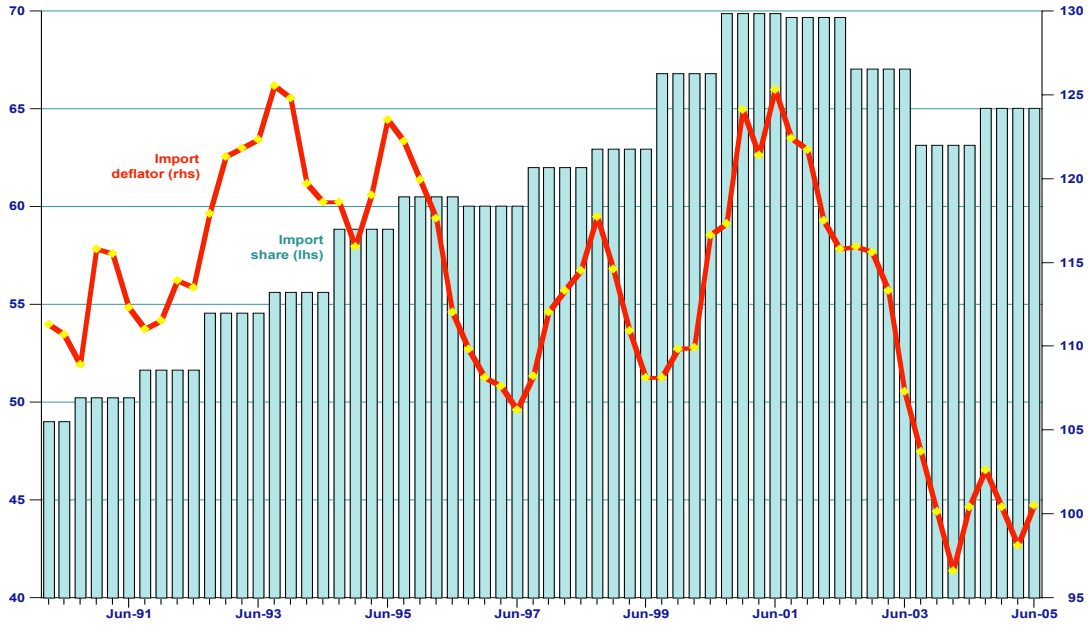


Source: ABS cat 5432, 5439. Data are for SITC 5,6,7 and 8 and are in billions of dollars.

2 b) Manufactured Imports

Chart 13

IMPORT SHARE OF MANUFACTURES MARKET CHECKED BY RISING DOLLAR



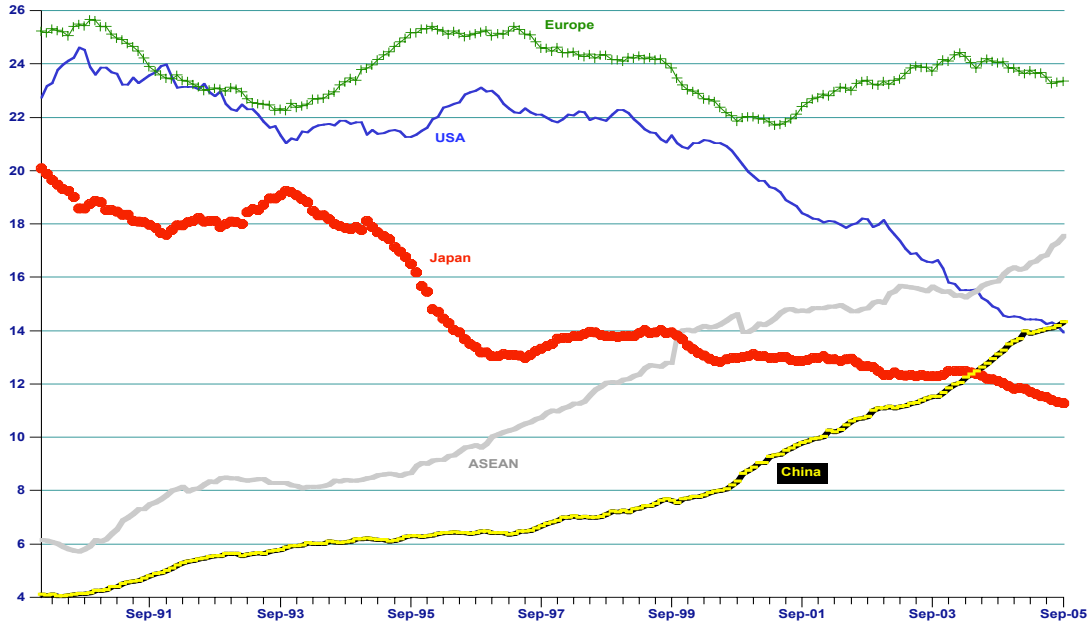
Source: ABS cat 5206, 5302 and 5439. Import share is merchandise imports (divisions 5,6,7 and 8) as % of manufacturing gross value added plus net imports. Deflator is implicit price deflator for merchandise goods imports.

The manufactured goods import bill has grown strongly for years alongside the strength of the Australian economy. Chart 13 uses a rough estimate of the import share of the Australian manufacturing market dollar stabilising in recent years after marked growth during the 1990s.[8]

The stability is, in large part, a function of currency appreciation earlier this decade. As the dollar rebounded and import prices fell, the size of the bill was held down. As the currency reached a plateau in 2004, import price falls ceased and the foreign share of the domestic manufactured goods market began to rise again.

[8] The size of the Australian market has been estimated as the sum of manufacturing gross value added (from the annual national accounts) and net imports for the four manufacturing trade categories (divisions 5, 6, 7 and 8).

Chart 14
SOURCES OF MERCHANDISE IMPORTS



Source: ABS cat 5439. Data are 12 month moving averages of imports by final place of origin as % of total imports. China includes SAR Hong Kong, Europe is EU25.

Reflecting the fast moving landscape of global production, there has been considerable change in the source of Australia's imports over the past decade. Chart 14 shows the shares of the merchandise import bill (over 80 per cent manufactures but declining) occupied by the major countries and groups.

Fifteen years ago imports came from Europe, the US and Japan with scarcely anybody else in sight. Today's pattern is much more evenly dispersed.

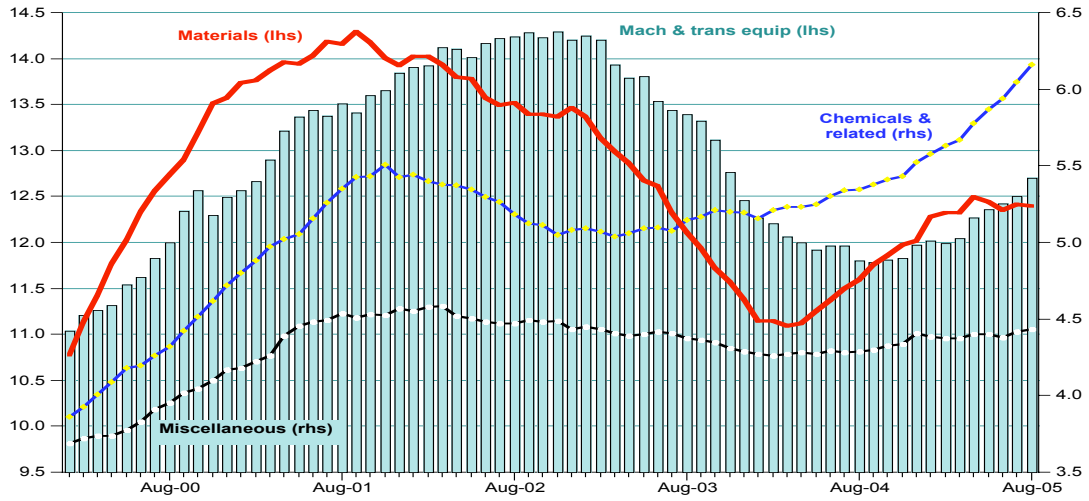
- Europe (including the UK and expanded to include 25 countries) has held its share.
- Both the US and Japan have fallen back in relative importance.
- The ASEAN nations overtook Japan at the turn of the decade and the US last year.
- China has been following the ASEAN penetration, the two lines over time being nearly parallel to each other, the moving annual total finally overtaking the US in recent months.[9]

China's growth of market share has accelerated since the turn of the century. Its rise together with that of the ASEAN grouping, is mirrored by the falls in the market shares of imports shipped directly from the US and Japan.

[9] Partly this is a figment of the data recording final point of embarkation for the imports' journey. As pan-Chinese production has come into vogue what were once Japanese exports of finished goods have become partly-finished exports to China and then Chinese exports to Australia. Thus the genuine Chinese element is overstated in the chart. Nevertheless there can be no doubting the direction of trends.

2 c) Manufacturing Export Shares by Broad Category

Chart 15
MOVING ANNUAL EXPORT RECEIPTS BY DIVISION



Source: ABS cat 5432. Data are in billions of dollars.

Three of the four manufacturing broad divisions have retreated from their peak export dollar hauls.

- Only the **chemicals and related products** division continues to post new peaks, mainly due to strength in *medicinal and pharmaceutical products* - areas assisted by higher feedstock oil prices containing revenue losses elsewhere.
- The recent partial recovery in the broad **"manufactures chiefly categorised by material"** division may also be partly due to commodity price trends.
- By contrast both **machinery and transport equipment** and the **miscellaneous** division are well off their peaks, though with a slight recent recovery.

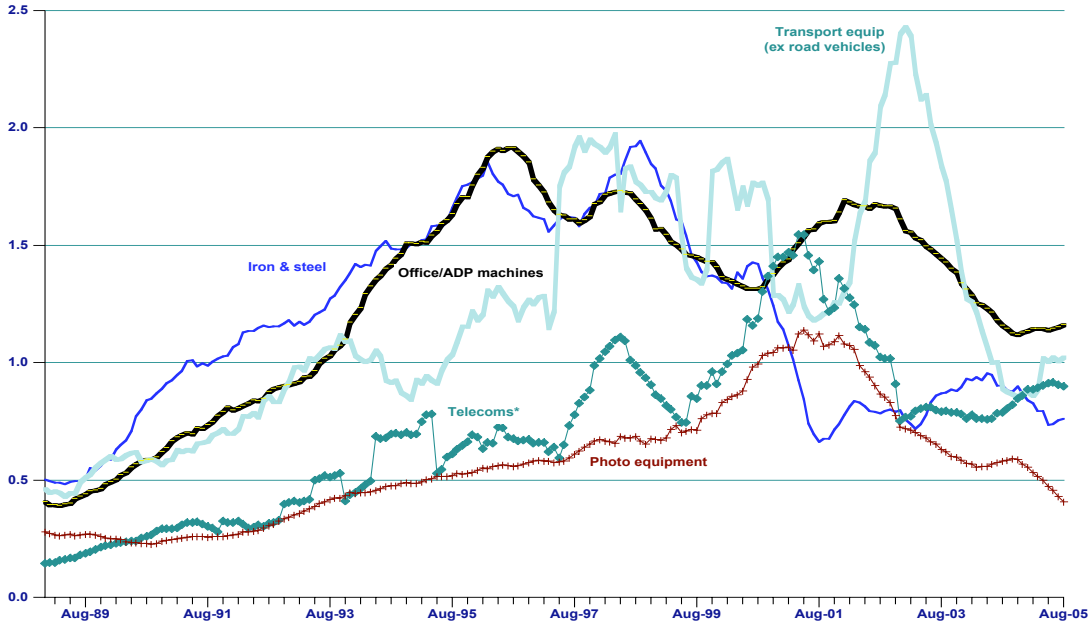
2 d) Losers and Winners

While there is the appearance of widespread loss of nominal export earnings in the manufacturing sector, the picture is dominated by some large-scale retreats. Compared with their previous peaks (three earlier this decade and two last decade) the latest annual tallies show the five industries in Chart 16 to have shed nearly 4_ billion dollars in export earnings.

The lost sales in these industries would more than account for the decline in manufacturing's aggregate export receipts.

Chart 16

FIVE MAJOR EXPORT REVENUE STREAMS ARE IN REVERSE



Source: ABS cat 5432. Data are moving annual totals in billions of dollars.
Telecommunications & sound recording & reproducing apparatus & equipment

- The biggest recorded slide amongst (two digit) manufacturing industries is in **transport equipment (excluding road vehicles)** apparently collapsing from record receipts of $2.4 billion in the year to January 2003 to just $1 billion lately.

  However, all is not what it seems and the peak was inflated by sales of Ansett planes following the airline's collapse. Occasional frigate sales, for instance in May 1997 and November 1999, further complicate this series. Confidentiality restrictions prevent the series being purged of these influences, but close inspection of monthly data suggests export revenue from the core business of catamarans, yachts and other boats and aircraft parts to have largely to have held up this decade.

- A second major reduction (at least compared with last decade) has occurred in **iron and steel**. Export earnings peaked at $1.94 billion in the year to September 1998, but then fell precipitously in the wake of the Asian crisis and the demise of the Newcastle steelworks to a low of $660 million in the year to August 2001. Subsequent Asian economic recovery has produced only a minor rebound (to $760 million in the year to August 2005) as strong domestic demand limited capacity available for export.

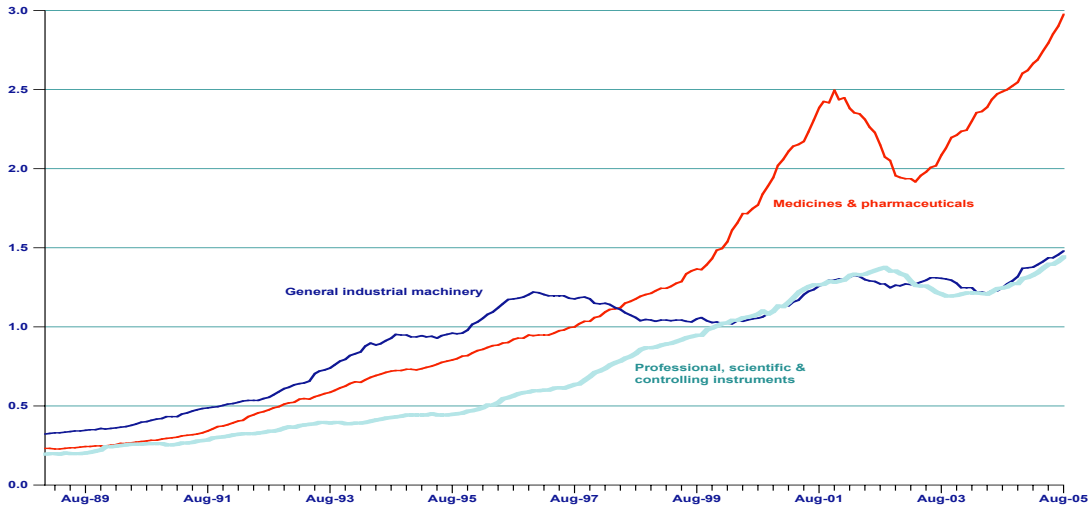
- **Photographic equipment** exports (down from $1.14 billion at May 2001 to $404 million now) have been victims of technological change as film gives way to digital methods.

- Similar, but lesser, changes have hurt the **office and ADP machine** sector (retreating from a peak $1.91 billion in June 1996 and $1.69 billion in January 2002 to $1.16 billion now) and the broad **telecommunications equipment** area (the May 2001 peak of $1.54 billion retreating to $896 million now).

Winners

Against the generally stunted trend for manufactured export revenues in recent years, some winners stand out.

Chart 17
MOVING ANNUAL EXPORT REVENUES FROM SELECTED WINNERS



Source: ABS cat 5432. Data are in billions of dollars.

Prominent amongst the winners (Chart 17) have been:

- the **medicinal and pharmaceutical** products;
- the **professional, scientific and controlling instrument;** and,
- the **general industrial machinery** industries.

Each of these industries earns annual export revenue above one billion dollars, and three billion in the case of the medicinal and pharmaceutical cluster.

There are also encouraging winners amongst small industries on the way up. Though too small historically to warrant their own (two digit) industrial classification, the data reveal growth in the miscellaneous sections of the broad (single digit) divisions.

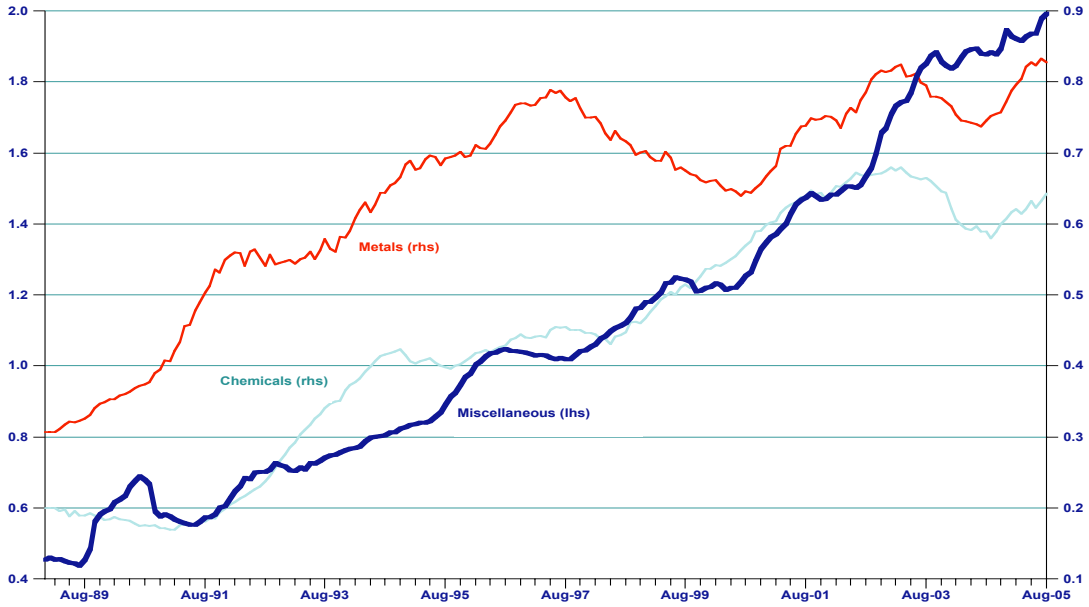
One of these residual collections was the *"general industrial machinery and equipment not elsewhere specified and machine parts not elsewhere specified"* referred to in Chart 17. Export revenues from two of the three remaining residual categories (*Metals, Chemicals and Miscellaneous*) are currently at record nominal levels, while a third is not far away (Chart 18).[10]

These winners have performed strongly in the difficult circumstances of the decade to date.

[10] Particularly noteworthy is the miscellaneous manufactures residual, the collection of which has added $773 million to its annual export earnings rate in difficult circumstances so far this decade.

Chart 18

ANNUAL EXPORT REVENUE FROM SITC DIVISION RESIDUAL INDUSTRIES



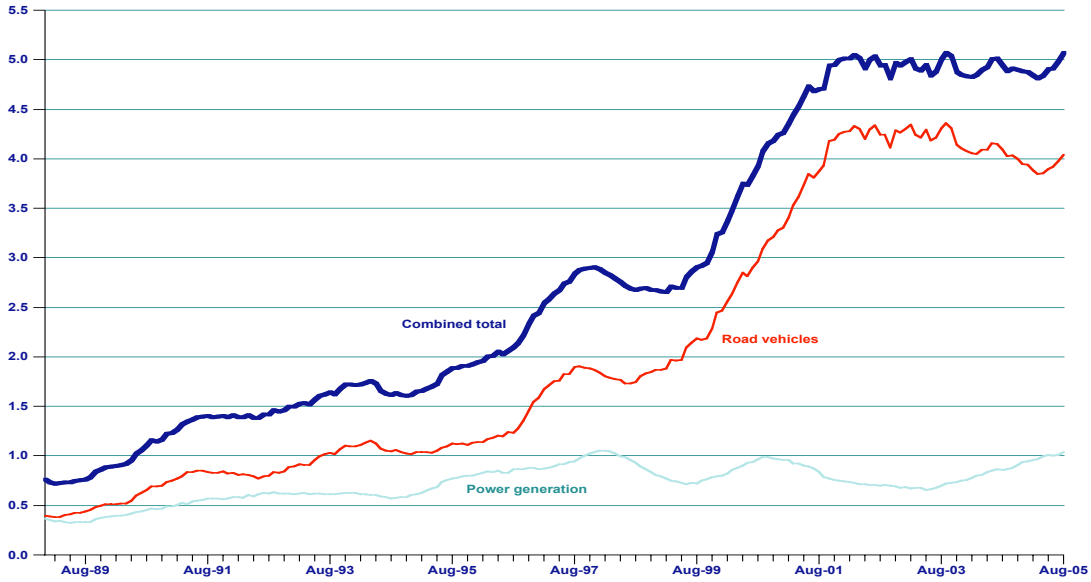
Source: ABS cat 5432. Data are moving annual totals in billions of dollars.

A Note on Vehicle Exports

In view of well-publicised recent difficulties note should also be made of the broad vehicle industry. In the face of a strong Australian dollar the latest annual export earnings for the combined road vehicles and power generation (mainly engines) industries were the equal highest on record (Chart 19).

Chart 19

SELECTED VEHICLE INDUSTRY ANNUAL EXPORT REVENUE



Source: ABS cat 5432. Data are moving annual totals in billions of dollars.

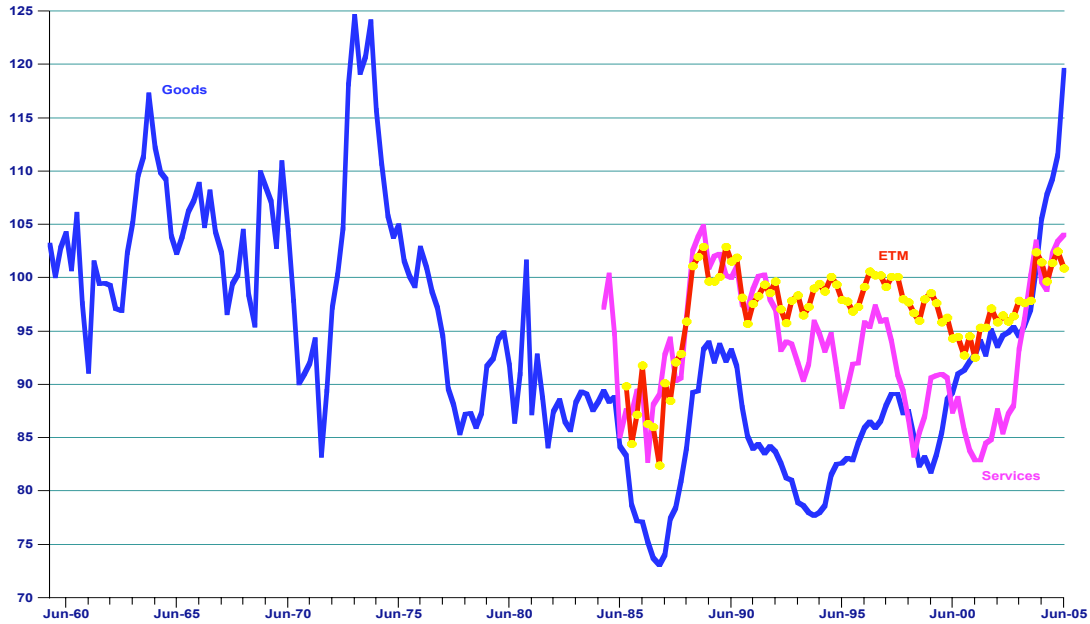
Part C. Balancing Risks and Building Economic Resilience

Australia faces risks that flow from the relative volatility of the commodity-price linked exchange rate. Additional risks arise from current patterns of global development and Australia's reaction to them. In particular, there are strong risks that the Australian currency will remain at high levels for an extended period. This risk poses questions both for business and for policy makers.

1. A Commodity Linked Exchange Rate

Volatile terms of trade (Chart 20) and the associated surges and drains of income have always presented potential difficulties for the Australian economy.

Chart 20
COMMODITIES' TERMS OF TRADE MOST VOLATILE



Source: ABS 5302. ETM terms of trade obtained as derived implicit price deflator for ETM exports divided by implicit price deflator for general merchandise imports.

Australia's relatively volatile commodity-linked exchange rate transfers to Australian producers a greater level of exchange rate risk than that experienced by producers in other countries.

At an abstract level aggregate headaches are neutralised by the close connection between the terms of trade and the free-moving currency. When the terms of trade have risen, primarily through commodity price gains, so too has the currency to about the same degree. Similarly, when commodity prices have fallen, the dollar has followed suit.

- During a perfectly-linked commodity price/currency rise commodity producers will not gain income on average as the currency increase nullifies the global price rise.[11]

- Consumers gain as the higher dollar improves purchasing power over cheaper imports.

- The consumer gains are offset by losses by domestic producers of non-booming traded goods and services.

While counteracting forces can emerge, even at an abstract level, commodity booms can be both a blessing and a curse – particularly for these traded goods and services sectors.[12]

- Typical examples can be found among most domestic manufacturers and a rising proportion of service providers.

- A higher currency will carry advantages through the lower costs of imported inputs (including capital equipment). These advantages are more generally overshadowed by the loss of export competitiveness and sharper import competition.

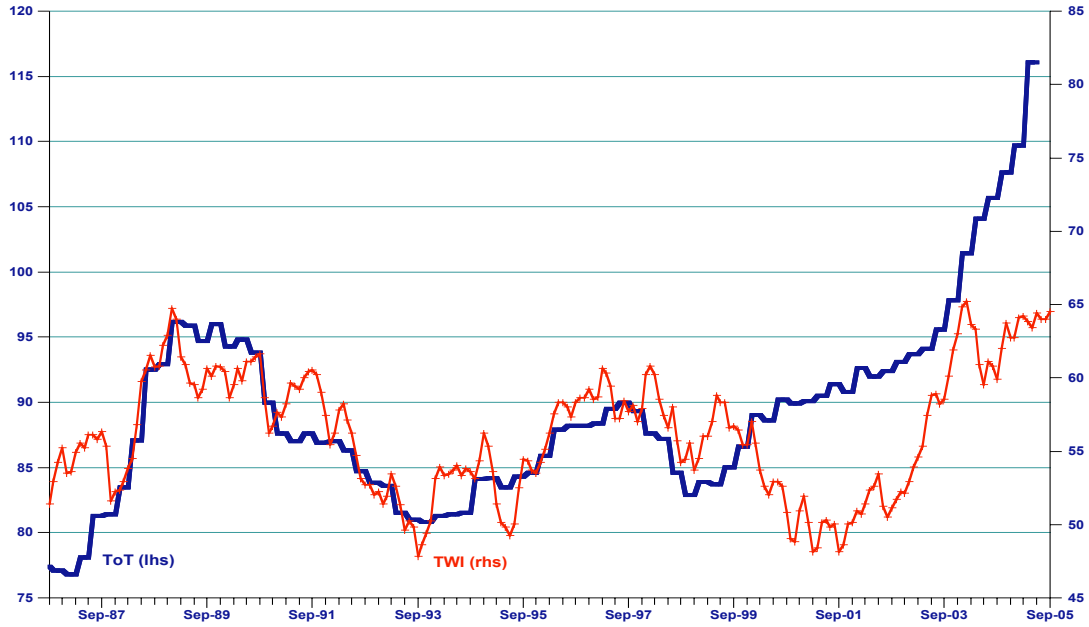
Of course these downside risks associated with the commodity-price driven currency appreciation, are mirrored by comparable upside risks for domestic producers when the currency is kept low.

[11] There will be individual winners and losers according to whether specific prices rise more or less than the average.
[12] These impacts are captured in the idea of *Dutch Disease* and its Australian counterpart - *The Gregory Thesis*.

2. A Decoupling of the Currency and the Terms of Trade since 2000

Chart 21 illustrates both the general close relationship between commodity prices and the (post-float) Australian currency and its erosion over the past five or six years.

Chart 21
TWI FAILS TO MATCH TERMS OF TRADE



Source: ABS. ToT is terms of trade for goods and services. TWI is dollar trade-weighted index.

An outstanding fact of recent history is that the Australian dollar decoupled from the terms of trade (Chart 21). This began at about the start of the decade and, after an extraordinarily rapid currency catch-up in 2003, has again undershot the balance of international prices.

During the first of these phases Australian producers faced near ideal circumstances. Unusually, the currency was weak while the terms of trade were solid. Domestic demand growth was very strong.

At the same time Australia managed to skip the early decade global recession and fuel booms in housing and consumer spending.

These exceptional conditions disappeared steadily over the following couple of years.

- Rising commodity prices eventually dragged the dollar up to long-term average levels by mid-2003.
- In early 2004 the currency reached levels not seen in nearly 20 years.
- The extent and the speed of adjustment once it got underway was remarkable.

Over 2003 the balance of risk faced by domestic producers in traded sectors swung rapidly from unusually favourable to unusually unfavourable.

One offsetting factor for domestic producers is suggested by the wide gap between the currency and the terms of trade since the start of 2004 (when the currency failed to follow the further surge in commodity prices) (Chart 21).[13]

This gap represents a powerful income expansion pumped into the Australian economy worth 3 percentage points of GDP from the end of 2003 to June quarter this year (the difference between real GDP and real net national disposable income growth). It shows up in swelling government coffers, in dividend streams (and dividend outflows), in investment spending and in stronger retail spending than might otherwise be implied by high fuel prices. It is an important prop to continued domestic spending to the advantage of local producers (and importers).

Crystal-Ball Gazing

How these forces work out is a matter of clear importance for the Australian economy. Much hinges on commodity prices and the exchange rate.

A Super Cycle?

Commodity prices are at dizzy heights. The latest June quarter reading for the terms of trade is the fifth highest reading in the 184 quarters on the national accounts record (and just 1.4 per cent beneath the September 1973 all-time high).

The future of commodity prices is, of course, a hotly disputed issue with some claiming current experience to be part of a "super cycle". At a fundamental level, there is clearly something to this view in light of the prospects for emerging economies discussed at the outset.

At the same time, others see pronounced mean reversion down the track as extra supply comes on stream (though not necessarily to the depressed, excess supply levels prevailing at the start of this decade).

While a correction would help ward off further currency rises (to the relief of domestic producers), the current disequilibrium evident in Chart 21 suggests the terms of trade can fall a long way before downward pressure will be exerted on the exchange rate. This is at a time when the trade weighted value of the currency is already at very high levels.

A correction that removed the pressures for a further rise in the currency would also wipe out some of the commodity-boom surpluses that are currently reinforcing domestic demand.

A soft landing for international imbalances?

The other major potential influence on the exchange rate is the large current account deficit. Australia's external gap appears stuck in a 5 to 6 per cent range in the absence of domestic recession. In previous decades that lower figure would still have been regarded as unsustainable and the currency dealt with harshly and promptly by markets.

[13] Had a tight link persisted the TWI would now be in the low 80s, some 30 per cent above its present position. It is worth noting that when the terms of trade last approached present values in 1974 the TWI traded above 110 on the official index and the Aussie bought above $US1.40. Even allowing for CPI differences in the interim the inflation-adjusted 1974 values of the dollar would still be well into the US 90 cents range.

Bernanke's hypothesis on the transmission of a savings glut around the globe appears to imply that global imbalances will gradually unwind as the excess savings start to disappear. In the meantime, as long as the savings glut persists there will be finance for deficit countries such as Australia. This might continue for years.

In RBA deputy governor Glenn Stevens' pithy phrase, "present imbalances cannot last forever, but forever is a long time".

While a gentler unwinding of global imbalances carries clear benefits – particularly for the deficit economies, it also implies a slow downward trajectory for the exchange rate and a more prolonged period of disadvantage for many domestic producers.[14]

3. Managing the Risk

For domestic producers in non-booming tradeable sectors there is a clear risk that the exchange rate will persist at high levels for some time. This will continue to stunt growth opportunities – both in the domestic market and in export markets - at present levels of productivity.

As we have seen (Chart 10), the strength of the Australian currency explains most of the "excess" loss of market share for Australian producers (relative to the rest of the OECD) evident since the early years of the present century.

Ai Group has recently undertaken an extensive process of consultation with Australian manufacturing businesses and has found that a wide array of strategies is being adopted in the face of this risk.[15]

- At the most direct level, these strategies include greater recourse to outsourcing - particularly from lower cost Chinese and ASEAN operations and accelerated consideration of opportunities for direct investment abroad. These strategies give Australian producers access to the cost advantages experienced by their competitors. In addition, the direct investment strategy improves the positioning of these companies to take advantage of the growth of demand in emerging markets.

- Additional strategies focus on domestic productivity. These vary widely and range from increased investment in capital equipment and in industrial research; experimentation with and introduction of new products and processes; workforce retraining and restructuring; to further "cost downs" and restructuring.

- An important third strategy is to concentrate on products and services with a high value-added content, so that squeezes on margins in lean periods do not imperil survival. Examples include the successful medicinal and pharmaceuticals industries where technological innovation affords margins accruing to first movers that can be adjusted to cope with adverse currency movements. Such strategies appear to be at the heart of the success of many of the "winners" among exporting manufacturers discussed earlier.

[14] It also implies a more significant accumulation of foreign debt.
[15] Ai Group will release the *Manufacturing Futures* report early in 2006.

More generally, particularly given the competitive challenge from China and the ASEAN countries, mass-market production based in Australia can only survive the cycle only when Australia has a large cost advantage, usually for natural reasons. For many industries these clear cost advantages are not available to Australian manufacturing, so that its survival depends upon creating and exploiting a series of niches.[16] Innovation, creativity, technology and flexibility are the keys to building the margins that offer insurance against lean times.

A role for policy?

What sensibly can policy do to plot a path through this variability? To a very considerable extent policymakers will not make the choices as individual businesses take the lead, assess the outlook and place their bets. Policy is no more likely to be adept at picking winners now than it ever was. Picking winners, be they today's winners or leading candidates for subsequent emergence, is not what policy is good at.

That is not to say that policy should turn a blind eye to risk. In fact, as a matter of principle policy should view economic evolution through a prism of risk and return.

The risk currently faced is that a prolonged period of high exchange rates will deplete the ability of the economy to respond with vigour and in a timely fashion when commodity prices fall. Notwithstanding the strategies adopted by private businesses (and in fact partly as a consequence of these strategies), there is some risk of a "hollowing out" of manufacturing capabilities in the current environment of high exchange rates. This is compounded by the strong demand for skilled workers (particularly in the traditional trades) from the booming mining and construction sectors.

Policy is far from all-powerful, but it is an important player in development. For instance, policy does play a critical role in the development of physical and human infrastructure. However, it is far from clear that adequate attention was paid earlier to the risks of strong demand in the mining and construction sectors. Australia would have been in a much better position to respond to the booming commodity markets if it had turned its attention earlier to looming skills shortages and to the efficient availability of bulk commodity export infrastructure.

At the macroeconomic level there is little doubt that the high dollar has checked the emergence of new exporters and hurt other sections of business whose domestic production might not survive into the era of more-normal terms of trade when their contributions will be needed. Policy has no direct control over the course of the exchange rate, so that the difficulties cannot be spirited away. Indeed the dollar has gained a well-earned reputation as one of the most difficult of economic variables to forecast, financial market enthusiasm switching seemingly quixotically from one set of determinants to another. But difficulty in targeting an impact is no excuse for neglecting the subject of what the current trajectory of the dollar might be doing to Australia's longer-term prospects.

Clearly the policy solution is not to wrap in cotton wool those sectors currently facing the pressures of a high exchange rate. That would certainly not benefit the evolution of the economy generally: nor would it stimulate the ability of these sectors to

[16] One example stems from the fact that the margins available to branded premium wine products are intrinsically more viable over the exchange rate cycle than bulk "commodity" product that can be sourced from other countries' producers when currency pressure hits.

develop the competitive capabilities required to underwrite their future contributions. Rather, a constructive role for policy that addresses risks such as that associated with the exchange rate while still avoiding the pitfalls of picking winners, is to encourage the development of capabilities that will support the process of industrial adaptation. Policy interventions that satisfy these criteria include:

- Investing in skill creation and development and in ensuring adaptability among training providers;
- Stimulating innovation through, for example, greater investment in and adoption of new industrial research; and
- Building better business capabilities - including in the important area of exporting.

A concerted improvement in these areas will assist in making the Australian economy more resilient and more able to address the variety of risks it confronts – and particularly the risks associated with a volatile exchange rate.