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Why exporters hate paying top dollar

The resources boom and high exchange rate may harm other sectors of the Australian economy

By **TIM HARCOURT**

PROFESSOR Bob Gregory of the Australian National University, one of the country's most eminent economists, retires this year. A past member of the Reserve Bank Board who has made a strong contribution to public policy, he is famous for a thesis on international trade known as "the Gregory effect".

The Gregory effect (also known as Dutch disease) refers to a situation where an export boom fuelled by, say, a strong demand for resources causes an appreciation in the exchange rate. This appreciation makes imports cheaper, and the knock-on effect is to hurt the competitiveness of other sectors.

Price rises in the boom export sector are offset by falling prices in import-competing sectors suffering from the appreciation in the exchange rate. As a result, we get an increase in the terms of trade (the price of exports divided by the price of imports) and a worsening trade deficit, as import growth outstrips export growth.

Are we experiencing a Gregory effect right now? After all, there's been supercharged demand for Australia's mineral exports from China — prices for coal and iron ore are at all-time highs — and the exchange rate has appreciated over the past couple of years. The terms of trade is in our favour, and manufacturing export volumes are flat.

Other factors may be in play. For instance, some economic commentators believe capacity constraints on the supply side are holding exports back, despite the strong levels of demand worldwide. Capacity constraints refer to factors such as bottlenecks in transport infrastructure, labour shortages and other limits to productive capacity.

In addition, there's also been an extension of the Gregory effect. A new thesis, proposed by the eminent physicist-turned-economist David Gruen, suggests that the economy, rather than being capacity constrained, is being driven by the high exchange rate, which causes a substitution of local consumption for imports.

According to the Gruen thesis any move to slow down aggregate demand may be unnecessary and could even cause an economic downturn. Instead infrastructure spending should be directed at improving the economy's productive capacity in the medium term.

So that's the theory, what about the practice? Are Australian exporters capacity constrained, or is the exchange rate doing all the work via the Gregory-Gruen thesis?

THE new DHL Export Barometer provides some evidence on the strength of these effects. The barometer, which is produced twice a year, measures a cross-section of the Australian exporter community to see how exporter sentiment about global business conditions is tracking.

In the latest survey export confidence has fallen, with the

Professor Bob Gregory, whose economic theories may be evident in Australia today. Picture: Gabriele Charotte main negative being the dollar. Around 58 per cent of exporters thought the high exchange rate was the most significant reason for a fall in export orders.

The Prime Minister's infrastructure taskforce, headed by ABARE executive director Brian Fisher, is examining capacity constraints. It is looking at the various issues affecting logistics, transport and related efficiency concerns.

According to the DHL Export Barometer, capacity constraints matter for one in four exporters, but transport infrastructure is deemed to be not as important as manufacturing capacity.

Of those exporters who mentioned capacity constraints as a negative, 67 per cent spoke of manufacturing capacity, 27 per cent transport infrastructure (road, rail, ports, sea) and 12 per cent supply chain blockages.

But the evidence was mixed about the Gregory-Gruen exchange rate effects. Surprisingly miners, farmers and tourist operators were much more worried about the exchange rate than manufacturers. Why is this so? One reason could be that many manufacturing exporters are also importers as well — 31 per cent of all exporters surveyed were also importers.

In manufacturing, the proportion is 55 per cent. Furthermore, many of them re-export what they import. They are basically part of a global supply chain in manufacturing through intra-industry trade.

'There's been supercharged demand for Australia's mineral exports from China . . . and the exchange rate has appreciated over the past couple of years.'

On the other hand, manufacturers also compete with imports and, as they become cheaper, it makes it tougher for them (particularly as they don't have the benefit of high commodity prices on the revenue side).

This is also part of the Gregory-Gruen thesis, which describes how consumers switch to imports when they are cheaper, at the expense of local manufacturers. This also implies that manufacturing producers will switch production as well when export markets get tougher. The only issue here is how many exporters are switchers.

Probably fewer than in the 1990s. According to Austrade surveys, about 45 per cent were "switchers, swingers, irregular or opportunistic" exporters in 1997-98. By 2003-04, this had fallen to around 32 per cent. As a result of trade liberalisation and economic reform, most exporters now see export markets as a core part of their business.

A second reason could be that manufacturers put up with a lot. Remember, this is a sentiment survey — it is about how business people feel. The confidence indicators show that manufacturers are positive. According to the export barometer, 70 per cent of manufacturing exporters believe orders will rise over the next 12 months, compared with 64 per cent of service exporters, 56 per cent of tourist operators, 53 per cent of miners and 51 per cent of farmers. This is a testament to Australian manufacturing exporters — many of whom are pretty new to the game.

If there is a Gregory effect at play, or at least a partial demonstration of Gregory-Gruen thesis, then one survey may not be enough to tell us.

Fortunately, there is consensus that the next 12 months should see better times ahead on the export front from the point of view of both economic analysts and exporters themselves.

And by the way, happy retirement Bob Gregory — and thanks for your contribution to economics and public policy.

Tim Harcourt is chief economist of the Australian Trade Commission.

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