



Contents lists available at ScienceDirect

Economic Analysis and Policy

journal homepage: www.elsevier.com/locate/eap

Full length article

Reconciling opposing views of the commodity boom



Anthony J. Makin*

Griffith Business School, Griffith University, Gold Coast 4222, Australia

ARTICLE INFO

Article history:

Received 17 February 2014

Accepted 12 May 2014

Available online 5 June 2014

Keywords:

Commodity prices

Dutch disease

Trade balance

ABSTRACT

This paper presents a new framework for reconciling contrasting interpretations of the impact of world commodity prices on the Australian economy. Focusing on the relative price of commodities to other goods and services rather than the real exchange rate, it shows that a commodity price boost alters the composition, but not the level of GDP, while simultaneously raising national expenditure and potentially creating a trade deficit which widens further with autonomous expenditure increases. Immigration and foreign investment facilitates long run economic growth, although this further contracts the non-commodity sector of the economy.

© 2014 Economic Society of Australia, Queensland. Published by Elsevier B.V. All rights reserved.

1. Introduction

Since the 2008–09 global financial crisis commodity prices have been at levels comparable to previous historical peaks reached in the 1970s according to broad based international commodity price indices (IMF, 2013). Driven by buoyant demand for mineral and agricultural commodities in Asia, especially China and India, and by central bank liquidity expansions worldwide, elevated commodity prices have significantly boosted Australia's terms of trade, the ratio of prices received for exports to prices paid for imports. The magnitude of these commodity price increases relevant to Australia is evident from Fig. 1.

Australia's resources exports have increased significantly since the turn of the century, with commodity exports, including minerals and fuels and agricultural goods, accounting for around two-thirds of Australia's total exports of goods and services, the top three exports being iron ore, coal and gold. Meanwhile, imports are mainly comprised of consumption goods, capital goods and services with manufactured goods accounting for over half (Department of Foreign Affairs and Trade, 2014).

There are two interpretations of the effects of heightened commodity prices on the economy. A pessimistic view highlights 'Dutch disease' effects, while an optimistic one interprets the boom as a national income windfall. Although a large literature has grown on 'Dutch disease' effects, very little research has been undertaken on the macroeconomic benefits of commodity price booms, with the exception of empirical work undertaken by the International Monetary Fund (see IMF, 2013).

Dutch disease economics grew mainly from the mid-1970s in the context of rising world energy prices and resource discoveries (see, for instance, McKinnon, 1976; Snape, 1977; Stoeckel, 1979; Forsyth and Kay, 1980; Corden and Neary, 1982; Bruno and Sachs, 1982; Buiter and Purvis, 1983; Enders and Herberg, 1983; Harberger, 1983; Corden, 1984; Van Wijnbergen, 1984). A key finding of this earlier literature was that the macroeconomic gains from a sudden expansion of commodity production for export were partially offset by costs borne by traditional industries elsewhere in the economy.

* Tel.: +61 755649165.

E-mail address: t.makin@griffith.edu.au.

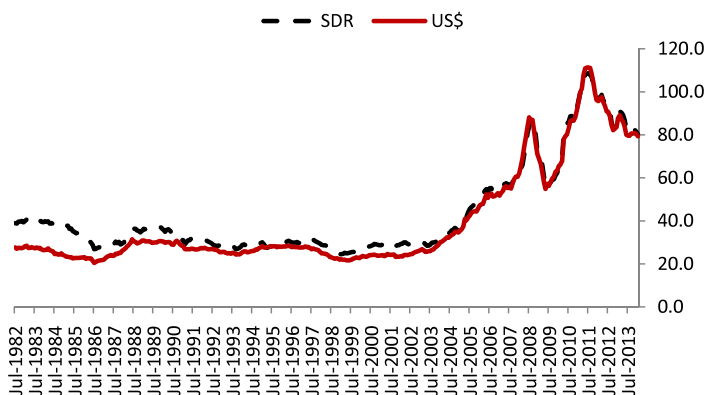


Fig. 1. World commodity prices (2008–09 = 100).

Source: Reserve Bank of Australia, available at www.rba.gov.au/statistics.

This result is also known in Australia as the ‘Gregory effect’ after the early contribution made by Gregory (1976). Others have examined the Dutch disease with reference to real exchange rate appreciations due to increased foreign aid flows (see Adenauer and Vagassky, 1998, Younger, 1992).

As noted in van der Ploeg’s (2011) recent survey on the nexus between natural resources and macroeconomic performance, all previous analyses of Dutch disease have been based on the distinction between tradable and non-tradable goods and services, which was first made in the Salter (1959) and Swan (1960) model of a small open economy. In earlier models, which abstract from capital accumulation, international investment and financial assets, the real exchange rate, defined as the ratio of the price of tradables to the price of non-tradables, plays the pivotal role.

As an economy’s export commodity prices rise, or new exportable resources are discovered, its real exchange rate appreciates, thus worsening the competitiveness of traditional tradable industries, most notably in the manufacturing sector. Real appreciation occurs, not only due to a rise in the nominal exchange rate, but in the price of non-tradables as a result of wealth-induced excess demand for non-tradables. What the Dutch disease perspective suggests is that in Australia’s case the expansion of mining, and to a lesser extent agricultural, production, has squeezed profitability and employment in non-commodity sectors via a high real exchange rate which in recent years has reached levels of forty per cent above its post-float average since 1983.

In contrast a positive view of the commodity boom is that higher commodity prices have increased the economy’s international purchasing power. This has enabled higher national spending, including on imports, and implies a rise in Australia’s standard of living. On this interpretation policymakers can justify the neglect of industry restructuring on the grounds that it is an equilibrium phenomenon and that for given supplies of factor inputs it reflects a necessary resource reallocation signalled by important relative price changes and hence is not really a disease at all. Reconciling this view with the Dutch disease perspective is the main aim of this paper.

The next section develops a framework for the analysis to follow. Section 3 then applies it to interpret the impact of a rise in world commodity prices on key macroeconomic variables in the short term. Section 4 considers the longer term macroeconomic effects of a terms of trade boost when the labour force and domestic capital stock are permitted to grow. Section 5 concludes the paper.

2. The framework

This section proposes an alternative theoretical framework for examining the impact of world commodity price rises on Australia’s national output, expenditure and trade balance. To do this, it departs from the tradition of specifying the economy’s goods and services markets as either tradables or non-tradables as the starting point for analysis. Instead, using mainstay analytical devices, it advances an alternative approach for analysing Dutch disease effects based on a different dichotomy, that between commodities and other goods and services.

Following Alexander (1952), it also invokes the distinction between national production and expenditure to interpret the impact of commodity price rises and government spending on exports, imports and the trade balance. Moreover, the analysis focuses on the role of the terms of trade, or ratio of exportable prices to importable prices in the internal and external adjustment process, rather than on the real exchange rate, defined as the ratio of the price of non-tradables to tradables, as in earlier explanations of the Dutch disease.

In this model there are two classes of traded goods and services—commodities, and other goods and services. Commodities (C) include agricultural and mineral commodities, whereas other goods and services (G) include manufactures and services. On the supply side of the economy, real Gross Domestic Product, the combined output of the C and G sectors, is conveyed by a production possibility frontier, as in Fig. 2.

Download English Version:

<https://daneshyari.com/en/article/5052758>

Download Persian Version:

<https://daneshyari.com/article/5052758>

[Daneshyari.com](https://daneshyari.com)