CAN AUSTRALIA COMPETE?
A PERSPECTIVE ON THE INTERNATIONAL
COMPETITIVENESS OF THE AUSTRALIAN ECONOMY

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DISCUSSION PAPER NO. 246

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Can Australia Compete? A Perspective on the International Competitiveness of the Australian Economy

Summary

When an economy, such as Australia's, encounters trading problems and current account deficits, poor performance of its tradable goods industries is frequently blamed for the loss of competitiveness. The solutions put forward to restore competitiveness include industry-based changes such as productivity improvements, export promotion, and reductions in input prices, such as the cost of capital and of labour. Such solutions do not address the core of the problem, and do not, in fact, result in increased competitiveness of the overall economy - they merely alter the pattern of competitiveness across industries.

Competitiveness is a price which results in the total expenditure in the economy being equal to the supply of goods and services. Only when overall demand relative to supply changes will this price, competitiveness, change. Industry level changes, such as making exports from an industry larger, will not alter either overall supply or demand, and thus they will not alter competitiveness - they will induce compensating changes in exchange rates or domestic price levels. After an outline of the theory, several industry-level policy changes, frequently argued to improve competitiveness, are considered. Even if exchange rates cannot be relied upon to ensure the appropriate trading outcome, it is unlikely that industry based changes will be able to do so in their place. By focussing on factors which are irrelevant to competitiveness, conventional discussion has led to insufficient attention to the actual determinants of trading performance and competitiveness. These are very much more difficult to influence.
1. **Australia's International Competitiveness**

When a country is encountering trading difficulties and incurring current account deficits, people naturally look towards the performance of its trading industries. Inevitably they find that the trading difficulties can be explained in terms of the poor performance of these industries - because of high costs, they will be losing share in export and domestic markets. Competitiveness (as measured by several indicators) will be seen to have declined. To lessen the current account deficit, it is necessary to "trade one's way out of one's difficulties", by improving the competitiveness of the trading industries. This can be done by reducing costs through greater efficiency or lower input prices, or improving the quality of their products. These might be achieved in several ways - lower wage growth, holding inflation down, lower costs of capital, export promotion, taxation changes and policies to improve efficiency within firms. Once competitiveness has improved, the trading position will improve also.

In short, the view is that the trading problem is caused by high costs relative to overseas, and that it is necessary to correct this to address the trading problem.

This view is common in Australia, as elsewhere. The high current account deficit is seen as a symptom of poor trading performance by Australian industries. Somehow, Australia has to reduce its costs so as to compete. It has had chances at doing this, for example with the 1985/86 devaluation, but the advantages gained were dissipated, through allowing costs to rise and competitiveness to be eroded. It is easy to point to the deficiencies of Australian industry, especially manufacturing, and indicate high costs, and the lack of interest in exports. To an extent it is not industry which is to be blamed, rather the environment within which it operates. This interest in industrial
competitiveness is not unique to Australia - when the U.S. started running large deficits, attention turned to the performance of its trading industries, which was found to be lacking (for a good examination, see Lawrence, 1984, and for an Australian discussion, see Harash (Ed.) 1988).

The perspective taken in this paper is that this approach is misconceived and misleading. The types of measures proposed to increase competitiveness and improve the trading position will not succeed because they do not address the fundamental determinants of the trading position and competitiveness. The trading position is a reflection, at the goods and services level, of a country's desired level of borrowing or lending, which in turn reflects the relationship of its desired spending level (on consumption and investment) to production.

Competitiveness is the price which equates the demand for, and supply of, goods and services in the economy, and it does this by adjusting the domestic supply of goods and services through altering the attractiveness of exporting and importing. It is not possible to alter competitiveness, by altering some of its components, such as the domestic price of exports, through efficiency increases or input cost reductions, when the home demand for, and supply of, goods remains unchanged. All that will happen is that other components, which are free to vary, such as the exchange rate, will alter to cancel out the change.

The implication of this is that if Australia's current account deficit is regarded as too large, attempts to reduce it by improving the competitiveness of trading industries will prove fruitless. This is because they will not address the fundamental determinants of the deficit, and thus they will not change the overall competitiveness of the economy. The roots of Australia's deficit do not lie in poor performance of its trading industries, or the lack of an 'export culture' - rather they lie in a desire to spend more than it produces, and this requires borrowing from abroad, in both financial, and real goods and services, terms.

There should be no doubt that it is possible to lessen the deficit and improve competitiveness - Australia can compete, if that is what is required. To do so, it is essential to reduce spending relative to production, and borrow less. This of itself will alter the demand for goods and services, and for exports and imports, such that competitiveness improves. It is necessary that competitiveness improve so that the flows of goods and services are altered, but this will come about as a response to spending changes. This change in competitiveness will normally be effected through a change in the real exchange rate. It could be effected through changes at the industry level, such as through improvements in efficiency in traded goods production. However, such changes are not necessary, nor are they particularly quick, and they are best assessed in terms of their benefits and costs rather than their impact on competitiveness.

While industry level changes cannot of themselves alter the overall international competitiveness of the economy, they can alter the pattern of competitiveness between industries. By making manufacturing more efficient, its share of exports will rise, but at the expense of other sectors, such as mining and agriculture. Some changes will affect the barriers to trade (e.g. shipping costs) and while they will not alter the current account deficit, or the overall balance of goods and services flows, they can result in greater exports and greater imports - i.e. a more open economy. However, the view that it is possible to improve the competitiveness of the economy by improving the competitiveness of firms or industries is incorrect because it is based
on partial analysis which fails to take into account other adjustments that will inevitably take place.

It is best to start by discussing the meaning of competitiveness, and then to examine the role, and determinants, of international competitiveness. After that, a range of different policy options, such as reductions in cost, tax changes, reductions in inflation and export promotion are examined in terms of their ability to improve competitiveness - with some specific exceptions, all are important. The questions of industrial structure and the pattern of competitiveness, and their lack of relationship to overall international competitiveness are discussed. Finally, the ways that Australia can compete, and whether it is desirable for it to do so, are considered.

2. The Meanings of "Competitiveness"

Competitiveness is a term which is often used, but there are several quite distinct meanings to it. For the purposes of the present paper, it is taken to mean international competitiveness, which relates to the ability of industries in the economy to compete with those overseas. In addition, there are at least two other senses in which the term is often used. One of these refers to the internal competitiveness of a market; the amount, and intensity of competition. It is usually clear when this sense is meant.

A third sense in which the term is often used is best exemplified in Porter's recent The Competitive Advantage of Nations (1990). Porter makes it clear that competitiveness is not to be understood as referring to international competitiveness, as referred to above (Porter, 1990, p.6). Rather, he defines the competitiveness of nations in terms of national productivity. Thus, in this sense, the US (with a large trade deficit) is a much more "competitive" nation than Japan (with a large surplus), though Japan is catching up in terms of competitiveness. Arguably, competitiveness in this sense is much more important than international competitiveness, since it refers to productivity and the standard of living, key objectives of economic activity, rather than the trading position, which simply reflects whether a country is borrowing or lending at the time.

It is often not clear which concept is being referred to. The recent Australian Manufacturing Council (1990) Report appears to use competitiveness in both senses. At times, competitiveness in Porter's sense is used, and Porter's work is explicitly referred to. At other times, it is clear that international competitiveness is what is being discussed, for example when it is argued that expansion of manufacturing exports would be needed to supplement other exports if the debt is to be stabilised or reduced. While several of its recommendations may enhance competitiveness in the Porter sense, they will have no effect on international competitiveness or the debt. Another recent example of the discussion of "competitiveness" without making it clear in what sense it occurs is in the I.A.C. Report on Non-Tax Charges (1989).

Within the meaning of international competitiveness, there are several distinct definitions or meanings - these can be mentioned though not discussed in detail here. One sense is the price of home goods compared to foreign goods - competitiveness increases as the ratio of home to foreign goods prices falls. Another sense is the ratio of tradable to non-tradable goods prices - a country becomes more competitive when tradable goods prices rise relative to those of non-tradables. In developing competitiveness measures, one might look more precisely at the prices of exports and imports and relate these to the prices of non-tradables (see Martin and Nguyen, 1989). Sometimes prices
as such are not used in competitiveness indicators, and measures of unit labour costs are used.

Different changes will affect these indicators in different ways. Thus productivity growth in export industries will change the relative price of exportables to non-tradables, though its impact on the relative price of importables to non-tradables, through exchange rate movements, will be different. Taxation changes can have different impacts on different indicators, depending on how they are structured. It is not appropriate to undertake a taxonomy of effects here, though it is important to specify the precise indicator of competitiveness being used when a particular change is being examined.

Another point worth noting is that there are three distinct aspects of trading performance that may be of interest, and they need not correspond. One is competitiveness as understood here. Another is the current account deficit. These two are closely, though not mechanically linked. It is quite possible for competitiveness to improve, but for the current account to remain unchanged (see Section 3 below). The third aspect is that of the openness of the economy, measured by the ratio of exports or imports to GDP. This can change with no change to the other two.

3. Competitiveness and the Current Account - a Theoretical Framework
(a) The Role of Competitiveness

The current account can be seen, most obviously, as measuring the net flows of goods and services, and thus it seems to reflect the relative prices of home and foreign goods - i.e. it seems to reflect competitiveness. However, it is also a statement of the net borrowing or lending by the country, and to this extent, it is a reflection of its intertemporal choices. A country has a level of goods and services made available through production, and if it wishes to be a net borrower, to finance expenditure greater than production, it can borrow on capital account. The real flow of goods to the country will be greater than the flow from it, and the current account deficit reflects the borrowing of real goods and services (see Pitchford, 1990, Ch.2 and Sjaastad, 1989).

Competitiveness should be seen as the relative price which enables the appropriate goods flows to take place. Suppose that a level of expenditure greater than production is warranted in the economy. If production is at a maximum, additional goods must come from overseas. If domestic prices rise relative to those overseas, goods will flow in - thus a fall in competitiveness is seen to accompany a current account deficit.

This is illustrated in Figure 1. Aggregate demand and supply are shown on the X axis and the inverse of competitiveness P* / P on the Y axis. Home production is OX, and it is unaffected by the relative price of home and foreign goods. Aggregate supply is shown by the curve S, and as the domestic price rises relative to foreign prices, more goods and services are made available to the domestic economy. At relative prices shown by C0, aggregate demand equals home production. Aggregate demand as shown by OD1, indicating that residents wish to borrow in this period - the level of competitiveness which will achieve this is shown as C1. As the country chooses to operate with a higher level of borrowing (current account deficit), competitiveness falls (P* / P rises) to achieve the desired balance.

Aggregate demand and production are shown as not being sensitive to competitiveness. Production is determined by factor availability, and intensity of use, and competitiveness will not affect these. Demand is, in the long term, constrained to equal production (assuming that the country pays its debts), but in any period, it can differ from
production (equal to income), as long as borrowing or lending are possible. Borrowing and lending will depend on income recipients’ time preferences, relative to the real interest rate, and desired investment levels (which also depend on interest rates, though it is a matter of debate how sensitive they are to them). A small country will either face a fixed interest rate, which it will not be able to influence, or possibly a fixed supply of funds schedule, which would be upward sloping due to increased sovereign risk with increased borrowing. Changes in competitiveness will have a slight effect in some cases, on real income, through the terms of trade effect, but they will not affect time preferences, the real interest rate, nor the attractiveness of investment in general (though they can affect the pattern of investment).

(b) Changes in Competitiveness

Changes to the equilibrium can come from internal or external sources. Suppose there is a desired increase in expenditure (to OD2), perhaps from an investment boom. Initially there is an increase in borrowing, pushing up the demand for the currency. There is also an increase in expenditure, and the higher exchange rate results in a switch towards imports and less exports. This increase in imports increases the availability of the home currency, and moderates, though does not cancel, the loss of competitiveness, which falls to the level indicated by C2.

Another change might be an export boom, where, at the going relative prices, foreign countries wish to purchase more domestic goods and services - this could be a mining or tourism boom. Such a change would not affect production or the desired level of borrowing, though it would affect the net supply of goods available at any given relative prices. Since the net supply would be reduced, the aggregate supply would shift to the left (to S2). The demand for home currency to pay for the exports would bid the exchange rate up, and lead to a loss of competitiveness (as happens during resource booms). The new equilibrium is shown with a competitiveness level of C3.

Finally, suppose a boom in foreign investment. This has effects much the same as a domestic investment boom, though its source is different. Additional investment in the home economy requires an increase in goods availability, and this is effected by a fall in competitiveness, and a rise in the current account deficit. A more liberal policy towards foreign investment, resulting in an overall increase in investment, leads to a higher current account deficit and a loss of competitiveness in the short run (and the reverse when returns are repatriated).

There is no correlation between competitiveness (or the exchange rate), and the current account deficit, because alterations in competitiveness can come about because of demand or supply shifts (just as there is no correlation between quantity sold and price of ordinary goods and services). Thus the US experience in the early 1980's of a climbing exchange rate, and declines in competitiveness, with increasing current account deficits is hardly surprising - it could have come about because U.S. residents wished to save less, or foreigners wished to invest more in the US - both of these were happening. Looking at trends in competitiveness will tell us little about what to expect on the current account, unless we know the source of the changes.

The model outlined above is not very different from the Swan model of Internal and External balance. (See Swan, 1955/1963.) External balance here is to be interpreted as the achievement of the deficit or surplus or current account which is warranted by the spending.
preferences, and production, of the residents of the economy. To achieve this result, there must be a particular ratio of home to foreign prices. Swan saw the problem as one with two objectives (internal and external balance) and two policy instruments (varying the overall spending, and varying the level of competitiveness). For present purposes, the level of domestic production and spending may be taken as given, and attention is being focussed on competitiveness. In an economy with a floating exchange rate, this is not a policy instrument but a price which is free to vary to achieve the desired balance.

A central proposition in this paper is that changes at the micro level can only affect the overall competitiveness of the economy if they affect the balance between overall spending and production, or alternatively, the balance between investment and savings. Most of the changes that are purported to change competitiveness will not do this, and thus they will not change competitiveness, or the current account. There are some changes that will affect competitiveness - for example, tax changes which encourage more savings. However, these are quite specific, and account for a small minority of those changes which are often asserted to affect competitiveness.

Suppose there is an improvement in the efficiency of an export industry, and its output prices fall. At a given exchange rate, it will be able to compete more effectively on international markets, and its exports will rise. There is no mechanism for such a change to have any significant effect on savings or investment, since the attractiveness of saving and investing remains the same as before. Real incomes may increase slightly, but most of these will be spent, and so savings will not increase by much. With the higher level of real incomes, investment may increase slightly as well. The balance between savings and investment, and thus the current account, and also the level of competitiveness, will remain essentially unchanged (for a similar argument in the context of general Microeconomic Reform, see Forsyth, 1990). The increased exports lead to an increase in the demand for the home currency, a higher exchange rate, and lower exports and greater imports of other goods and services. (For a discussion of Japanese supply-side changes, and their impact on the exchange rate, see Yoshikawa, 1990).

The reason for this result is that changes at the level of the traded goods level, for example, making exports cheaper, do not normally affect intertemporal choices; i.e. choices about when the economy's production is to be spent. These will depend on several factors, including the relative price of present and future consumption, the interest rate. While short term differences in real interest rates can be sustained, long term differences tend to be eliminated. When there is a disequilibrium between exports and imports, the price of the price that is free to vary is the real exchange rate. When exports from one industry become more attractive, competitiveness alters to re-establish the equilibrium between aggregate spending and supply.

Some changes at the tradable goods level can be seen as temporary, and thus they can impact on the current account. A temporary boom in export prices will translate into a temporary rise in real incomes, and a high proportion of this rise will tend to be saved. Thus a temporary export boom leads to a reduction in the current account deficit, whereas a permanent one does not.

It is worthwhile looking at Australia's trading performance during the years of the mineral boom as a test of the propositions here. On the face of it, they may appear to contradict them, since, in the 1970s, when the boom was gathering pace, Australia recorded trade account surpluses, and occasional current account surpluses. However, what is
striking is how small an effect the export boom had on the trade account. The turnarounds in the 1970s in the trade and current accounts were much smaller than the increase in mineral exports, and by the 1980s, the impact had completely evaporated. As is consistent with the analysis, the real exchange rate rose, and put pressure on traditional export and import competing industries. By the end of the 1980s, the mineral export boom was greater, in absolute terms and relative to total exports and GDP, than ever before, but the current account deficit was also a record. At the most, it might be claimed that the mineral export boom had a muted, and temporary, impact on the current account deficit.

Even this, however, may be going too far. There were other changes taking place in the economy at the same time, and these may have had more to do with the trade surplus. From the mid 1970s on, business expectations were weak and investment spending was low. During the 1970s, measured household savings rose - it is not clear just why this occurred. Overall, the 1970s were a time of stagnation and inflation, and peoples' savings and investment behaviour altered; this was reflected in the trade and current accounts. It is quite possible that there would have been a similar trading outcome even if there had been no mining export boom.

It does seem counter-intuitive that changes at the tradable goods level cannot affect a nation's trading position. It is hardly a new proposition, however. This view of competitiveness is embodied in most basic trade theory - for example, when a tariff is imposed, it is normally modelled to indicate a change in goods flows, but not the current account balance. This latter is often set at zero, in a normal, one period model - when a multi period model is used, positive and negative current account balances are possible, but they are determined by expenditure and production decisions. This view of competitiveness is reflected in intermediate texts (see, e.g. Hall and Taylor, 1986, p. 278-9) - nonetheless the notion that it is possible to alter the current account and competitiveness through industry level changes is widespread (probably because it seems so plausible).

Once there has been a change in the underlying spending/production balance, competitiveness will change so as to ensure this comes about. This may, but does not necessarily, involve the nominal exchange rate changing. It can be argued that exchange rates are subject to many influences, and do not always perform well as equilibrating prices. This argument has been put by the OECD (1990), which considers that various measures such as productivity improvements and holding down nominal wages are needed to improve competitiveness.

(c) Do Exchange Rates Adjust Effectively?

Firstly, the question of the performance of exchange rates must be addressed. It is by no means obvious that they have failed to perform, in Australia or anywhere else, over the medium to long term. It is possible that those who are sceptical of exchange rate performance have in mind such events as the 1985-86 devaluation and the lack of a sustained impact on the current account. However, it must be remembered that the exchange rate is not a mechanism for achieving a low or zero deficit on the current account - it is to produce whatever deficit is warranted by the fundamentals. In Australia, the devaluation did not work because the savings and investment levels were inconsistent with a reduced current account deficit.

For the exchange rate mechanism to have failed, it would need to have been the case that overall demand and supply would have been in imbalance. The symptoms of this would be, if the exchange rate were too high, excess supply in the home market. For example, producers or importers would be unable to sell goods, and stocks would be mounting
up. Lower domestic prices would be called for, but prices would be remaining high (i.e. the real exchange rate would be excessively high). An example of this, in one market, arises with the wool stockpile that has come about through having a reserve price above the equilibrium price. If exchange rates were falling, a similar situation would be evident throughout the economy. This does not appear to have been the case in Australia - the exchange rate rose, and competitiveness fell because people wanted to continue spending.

Thus, exchange rates will only seem to fall if they are expected to perform a task which is not their function - lessening the current account deficit. They will only be falling if there is evidence of imbalance in the goods market. This would be less obvious than a current account deficit, and it is an indicator which is usually not even looked for.

It should be recognized that the nominal exchange rate is volatile, subject to a number of influences, and it may be prone to overshooting. It is possible that it will be set, for a period, at levels which are inconsistent with goods market balance. It is set partly according to expectations, and these expectations can be wrong or ill-informed. Thus, when spending decisions change, and a new exchange rate is warranted, the path to the new equilibrium may not be smooth. Partly because no-one will know sufficient about relevant elasticities to forecast the new equilibrium rate. However, there are mechanisms to bring the exchange rate, or competitiveness, into line. For example, if the rate has been set too high, the supply of the home currency, to purchase imports and invest abroad will be higher than the demand for it, pushing the exchange rate down. Within the domestic market, the build-up of stocks will put pressure on domestic prices, and a fall in prices (or a lower rate of inflation) will raise competitiveness. It is not necessary that the nominal exchange rate adjust. If exchange rates are being set by market participants at an inappropriate level, pressures will be present to change them; these pressures will become effective in the short to medium term.

(c) Can Industry level Changes Improve Competitiveness?

Thus, competitiveness will change to bring about the warranted current account deficit, and specific measures such as making exports cheaper, through productivity increases, are not necessary. But would they help? The OECD (1990) clearly thinks so. However, even this proposition must be taken with a degree of scepticism, since it makes strong assumptions about the movement (or lack of it) in exchange rates.

Suppose exports become cheaper and export revenues increase. If the nominal exchange rate, and other variables such as imports, remain the same, the current account deficit will be reduced. This may be warranted by the balance of demand and supply for goods. But can exchange rates be relied upon to remain constant? It seems a strange argument that they are set at inappropriate levels, yet they will stay unchanged while other adjustments are made to achieve the desired level of competitiveness. In fact, changes such as the one proposed will automatically put pressure on exchange rates to alter - the export boom will lead to an increase in the demand for the local currency, pushing its value up. In such a case, the export price fall will fail to achieve the appropriate level of competitiveness, or the desired current account result. If there are reasons why the nominal exchange rate is failing to adjust appropriately, it is unlikely that it will be possible to keep it constant and make other changes to achieve competitiveness.

It should be noted, as well, that if productivity improvements are to achieve a rise in competitiveness, consistent with a reduced excess of demand over supply and an unchanged exchange rate, it could be
necessary that they be confined to the tradables industry. If there are productivity gains, and price reductions, in non-tradables, there will be demand shifts within the domestic economy - non-tradables are not simply inputs into tradables. The level of competitiveness which will achieve balance will change, and quite possibly increase. Since there are no reasons on efficiency grounds for restricting reforms to achieve productivity gains to the tradables sector, this suggests that productivity growth is not a good way to increase competitiveness.

The discussion above has taken a fully employed economy for granted, though economies such as Australia’s cannot be considered fully employed. The nature of the unemployment has a bearing on the analysis, and it can be argued that unemployment has been such in Australia as to be consistent with the analysis above. It does not appear to be the result of aggregate demand deficiencies, and it has not been much reduced even though there has been a sustained boom. Changes in demand relative to supply appear to be resolved through the external sector, with alterations in the current account deficit. This corresponds with the assumption made in the analysis above.

In summary, only under very strict, and rather unlikely circumstances, will changes at the industry level improve international competitiveness. If exchange rates work effectively (and those who doubt this usually misinterpret their role as one of eliminating current account deficits), industry level improvements will merely raise nominal exchange rates. If exchange rates do not work effectively, chances are that industry level improvements will still just raise exchange rates. For such improvements to help, it is necessary that (a) aggregate demand falls relative to supply (b) nominal exchange rates are unaffected by them and (c) other mechanisms, such as domestic prices, do not alter to achieve balance. These conditions are very restrictive.

4. Industry Level Changes and Competitiveness

There are a number of changes or policies which are often claimed to have a favourable impact on competitiveness, or to reduce the current account deficit. In most cases, these changes will have no such effect, though there are specific changes that may have some impact, even though for reasons different from those usually supposed. Various possible changes are considered here in the light of the discussion in Sections 2 and 3.

(a) Industrial and Export Industry Performance.

The notion that more efficient performance, by the export and import competing industries in particular, and by industry in general, is a commonly held, though incorrect, one. Basically the problem is that having more efficient export industries, able to sell more because of lower prices, will not do anything to alter the spending/production balance - it does not make it any more attractive to save more or invest less. There will be an increase in real incomes, which will be generally much smaller than the effect on exports, and some of this income will tend to be saved. As against this, there will be some need for increased investment in the economy, as overall production increases (possibly to enable the production increase). As the industrial composition changes, there may be changes in the distribution of income, and these would affect saving - this effect is unlikely to be large or systematic however.

In the absence of a change in savings investment patterns, the gains in competitiveness from lower priced exports will be eliminated by exchange rate changes, or domestic price changes (pressure of demand against supply pulling up prices in the home economy). A country’s
trading performance is not determined by how competitive its tradable industries are - rather, causation is in the reverse.

If there are savings/investment balance shifts, and these are accompanied by efficiency improvements at the industry level, it may seem that the latter are contributing to the improvement in competitiveness. To the extent that the efficiency gains are restricted to the tradables industries, the lower prices will be consistent with the competitiveness gain. They are not necessary for it, as it would have come about through a lower exchange rate. If exchange rates cannot be relied upon to ensure equilibrium industry efficiency gains may help; however they could simply result in a higher exchange rate, just as when exchange rates do work. If efficiency gains extend to non-tradables, the effect on competitiveness is ambiguous.

(b) Exports and Export Promotion

When exports from a particular industry grow, this does not mean that total exports grow, or that the current account deficit falls. When there is an export boom, there need not be any substantial change in real income, production or spending. In some cases, e.g. a mining boom, real income may rise and there may be rents generated. It is possible that a high proportion of these rents would be saved, especially if the boom was expected to be short lived (see Forsyth, 1986). If so, the current account deficit would be reduced. The mining boom in Australia does not appear to have generated enormous rents or perceivable shifts towards savings however. If we consider a currently booming industry, tourism, the rent component is quite small, and any positive effects on saving are likely to be correspondingly small.

Export booms, resulting from external demand shifts, reduce competitiveness, but do not affect the current account, unless they generate rents and these are saved. They will alter the relative competitiveness of industries; they make other industries less competitive. They may result in an increase in exports and imports, and result in a more open economy. Such an economy may be more exposed to international competition and it may become more efficient - it will not become any more effective in terms of its trading position.

Increased exports may not come about only through external demand shifts - they might be the result of export promotion. Thus, there may be expenditure abroad to increase demand for exports, or exporters may be subsidized to more effectively market their goods. Such efforts will alter the pattern of trade, though not the current account, since the better one industry does, the harder it will become for others. Ironically, export promotion has the effect of making the measured competitiveness of the economy fall.

There are other ways in which exports are supposed to be increased. It is frequently said that it is important that investment be directed towards the tradable goods industries, and not to non-tradable goods, in order to build up the country's capacity to export and compete with exports in the future. Such investment may increase the efficiency and capacity of the tradable goods industries, but it cannot result in a change in the current account deficit. All that it will do is to alter the patterns of competitiveness among industries. When there is an investment boom, the current account deficit can be expected to be higher than it will be in the future, but this is because of the boom's impact on total spending. The subsequent reduction in the current account deficit is not because of the investment in the tradables sector, and it will come about if investment has been confined to the non-tradables sector.

The notion that Australia needs an "export culture" to enable it to trade its way out of current account difficulties is a complete
misreading of the situation. Countries do not operate current account surpluses because they have enthusiasm for exporting or are especially effective in doing it. Rather it is because they wish to save more than they wish to invest at home, and thus must run a current account surplus to do so. Thus countries like Japan and Taiwan appear to have an "export culture", but because competitiveness must vary to enable a high level of exports, they appear to be good at it. No matter how much of an "export culture" Australia develops, it will still have the same current account outcome.

(c) Protection

Changes in protection have the same impact on the current account as do changes which make exports cheaper - that is, none. Thus, increases in protection will not lessen the current account deficit, and perhaps more to the point, reductions in protection can be achieved without any deterioration in it. By contrast, much contemporary discussion of efficiency in export industries seems to take it that increases do have an impact on the current account.

(d) Keeping Inflation Down

The view that, by keeping inflation down to the level of, or below that of competitors, competitiveness is enhanced is common, though it conflicts with the widely accepted theory that differences in nominal interest rates, and inflation rates between countries will be cancelled out by exchange rate changes. (See Krueger, 1983 Ch.4). If this theory works, reductions in inflation will simply be matched by exchange rate increases. In fact, this strict relationship between interest rates, inflation and exchange rates does not hold exactly, at least in the short to medium term (consider Australia's recent experience, for example). These observations do not disprove the theory, because there is no presumption that real competitiveness should hold constant over time. Furthermore, even if it is considered exchange rates do not adjust appropriately, it does not follow that, by holding down inflation, competitiveness will increase - exchange rate rises can still cancel out the gains from reduced inflation. It all depends on what the precise failure of the exchange rate mechanism is.

(e) Taxation Changes

It is argued by some that changes in the taxation system will improve competitiveness or the current account balance. Thus, in recent discussion of a consumption tax, it has been claimed that it will assist exports, because under a consumption tax exports would be exempt, while under present arrangements, they are not. Such changes will alter the relative competitiveness of different industries, but for the same reasons as discussed above, they would not alter the overall competitiveness of the economy. Exports might increase, but so would imports.

Tax changes can, of course, result in changes in competitiveness, through their impact on spending and production. Changes which induce an increase in saving relative to investment will reduce the current account deficit and achieve this through an increase in competitiveness. If the move to a consumption tax was accompanied by a move to lower marginal rates of income taxes, the real return to savers might increase (if interest rates are not influenced by the tax system) and this in turn, might give rise to increased saving (if savings are positively related to interest rates). The insensitivity of savings to real rates of interest in Australia over the 1970s and 1980s (perhaps there is a negative relationship) suggests that there is unlikely to be any major impact from this source.
(f) High Input Prices: The Cost of Capital and Labour

It is possible that, in Australia, exporters and all other producers face a cost of capital which is high relative to that of other countries. This remains to be shown, but if it is the case, it does not follow that it results in reduced competitiveness. A high cost of capital might be due to high real rates of interest, high rates of inflation and thus high nominal cost of capital, and high taxes which must be paid on after-interest profits.

Even if the cost of capital is systematically high due to taxation (which may interact with inflation to make the cost of capital, in real terms, higher), this will be a higher cost faced by exporters, but if the exchange rate is free to adjust, it will be offset by a lower exchange rate. If the exchange rate fails to adjust appropriately, it again does not follow that balance can be restored by reducing the cost of capital. In recent times in Australia, high interest rates have not caused a loss of competitiveness directly, but to the extent that they have attracted capital inflows, they will have resulted in the need to have lower competitiveness to enable the real flow of goods and services warranted by the capital flows.

If the cost of capital were to be reduced, it is likely that competitiveness would decline in the short term, and then increase. A lower cost of capital would increase the desired level of investment, and this would need to be met by capital inflow. The current account would deteriorate, but when the investment boon subsides, and repayment of interest and capital begins, the current account and competitiveness would improve.

It is not necessary to discuss wages in detail. To the extent that they are a cost to industry, the analysis is the same as that for the cost of capital. Competitiveness is not enhanced by holding down real or nominal wages. Wage changes can lead to changes in the distribution of income, and alterations in savings through this. It is likely that very considerable reductions in wages would be needed to produce a substantial impact on competitiveness.

(g) The Development - Environment Trade Off

It is sometimes put that export-oriented resource projects create exports, and that granted the current account deficit, this is a benefit, which can be offset against any environmental costs they might have. It should be clear from the analysis above that there is no benefit from this source since extra exports will not reduce the overall current account deficit, and that an "export versus the environment" trade-off does not exist. Resource developments should be assessed in terms of the benefits they produce, and the costs, environmental and other, which they impose. They should not be considered necessary or useful in reducing the current account deficit however.

5. Competitiveness and The Structure of Industry

As discussed above, there are many industry policies which are advocated on the grounds that they will enhance competitiveness and reduce the current account deficit. It has been argued that such claims, in most cases, have little or no justification. These policies then need to be assessed in terms of their other effects - as such they can be desirable or otherwise.

Some argue that it is inappropriate for Australia to rely so heavily on resources and agriculture as exports, and that there needs to be more reliance on manufacturing (e.g. Australian Manufacturing Council, 1990). Others might argue that Australia's Research and Development effort is deficient, and more exports of high technology goods is what is called for. Canes for these views can be made, but
these will essentially be in terms of the patterns of competitiveness and the industry structure being inappropriate. The industry structure problem has nothing to do with the overall international competitiveness of the economy.

It may be that Australian exporters, through lack of knowledge or experience, may be ignoring good opportunities; to this extent, if there is a market failure, export assistance could be justified. (See Committee for Review of Export Market Development Assistance, 1989 ch.4). It is possible that some of the benefits of expenditure on export development may be reaped by other than those incurring the expenditure. For example, private tourism promotion may bring more tourists, and some of the expenditure of these tourists may go as taxes to governments. If so, assistance for this promotion could be justified. The case for and against export promotion or assistance should be assessed in terms of the market failures that may be present, not any supposed effect on competitiveness on the current account.

6. Conclusions: A Perspective on Competitiveness

It has been argued that the conventional view, that Australia is insufficiently competitive, and that, to reduce the current account deficit and, ultimately the debt, improving competitiveness through reducing costs is called for, is a misreading of the situation. It is worthwhile considering how useful competitiveness is as an indicator, and whether Australia can compete.

(a) Competitiveness as an Indicator

It should be apparent, especially from Sections 2 and 3, that competitiveness is not a particularly useful indicator. It is always possible to examine changes ex-post, and interpret changes in competitiveness. Thus, after an export boom, competitiveness may be seen to have declined - this would be an example of the booming sector effect. Alternatively, exports may have boomed and this may have been accompanied by a rise in competitiveness - this would be consistent with a reduction in investment or an increase in savings in the home economy. Competitiveness of itself, does not tell us very much - we need to know what is going on in terms of its determinants. In fact, we are more likely to be interested in these - the current account deficit and, in turn, its determinants, spending and production, than competitiveness itself. It is in these that we find an indicator of the way the economy is performing, rather than in competitiveness, which is simply the relative price which enables a particular balance, in terms of goods and services, to come about.

Competitiveness might be a useful indicator if it were also a policy lever which could be adjusted so as to bring about a desired current account result. The problem is that it is not, and specific policies to alter competitiveness will not do so since, with unchanged fundamentals, they will simply bring into operation compensating adjustments. Trying to adjust the trading position by altering competitiveness is like trying to change the quantity of goods traded in a market by setting maximum or minimum prices when a black market is readily available. It will not change the quantity traded, since it will simply induce compensating adjustments in the black market to take effect.

(b) Can Australia Compete?

There should be no doubt that Australia can compete, if that is what is required. Fundamentally, what is needed is an alteration in the balance between spending and production, in the direction of raising the latter relative to the former. If this happens, Australia will run a smaller current account deficit, and debt could be stabilised. Its
Industries will become more competitive, through a reduction in the real, though not necessarily the nominal, exchange rate.

It must be seriously questioned whether it is advisable for Australia to compete more effectively, since the present trading outcome could be optimal. This is a possibility raised by Pitchford (1990). If savings and investment decisions are based on insufficient information, and there are no distortions in the relevant markets, the actual outcome would be the most efficient one, and the build up of the debt is simply due to Australia financing worthwhile investments. If this is so, there is no advantage in Australia becoming "more competitive". It is possible, however, that there are distortions to savings and investment decisions, which result in an inappropriate (and possibly too low) level of savings, and the existence of unfunded pension schemes may mean that the country as a whole is saving too little. If so, a lower level of expenditure is called for, and likewise a lower current account deficit is appropriate. Achieving this would lead to greater competitiveness - in this sense, it could be said that "Australia should become more competitive".

By lessening expenditure relative to production, forces would be set in train to improve competitiveness. These cannot be guaranteed to work - if they do not, the markets for goods and services would not clear, and there would be an unwanted accumulation of stocks. However, there are several ways in which they can work, and they do not need to work through the exchange rate. The fact that in most developed countries it is not the case that severe and sustained excesses or deficiencies of supply over demand occur suggest that the mechanisms do work. Exchange rates are sometimes thought to fall because they do not do something that is not their role to do, namely reduce the current account deficit (or surplus) to zero or some other specified level.

Changes at the industry level to increase exports or make the economy more competitive will fail. They cannot have an impact unless they change the balance of expenditure and production, and, expect in special cases such as taxation cases, there is no mechnism for them to do this. All that they will do is succeed in achieving the same result at a higher exchange rate. This is likely even if the exchange rate is falling as an equilibrating price - industry level changes can reduce the domestic price of tradables, but they will only improve competitiveness if the exchange rate remains unchanged and also spending is reduced relative to production. There are no mechanisms to hold the exchange rate constant, and to the contrary, there will be forces operating automatically to increase it. Thus, industry level changes may not only be unnecessary, but also of little help, in improving competitiveness even when other mechanisms such as the exchange rate are failing to achieve equilibirium in the goods and services markets.

If Australia's trading performance is a problem, focussing on industry and export performance, however poor these appear to be, is focussing on the symptom, rather than the cause. Little or nothing can be achieved by addressing these symptoms, and any improvement must be achieved by addressing the expenditure/production balance. In theory, this is straightforward, though in practice, it may be quite difficult. It is possible to alter the balance in the short term by pushing the economy into recession, depressing investment spending, and the ratio of spending overall to production. However, as soon as the economy recovers, the problem will re-emerge. To obtain a long term solution, a secular shift in the expenditure/production balance is required and this is very difficult to achieve. If investment is not to be reduced, the government must somehow engineer an increase in saving. If it does this itself, through running an increased budget surplus, it must ensure that
the private sector does not reduce its saving to cancel out its increase - to an extent, this is likely to happen (see the discussion in Alesina, et. al. 1990). Alternatively, it can try to make the private sector choose to save more, by increasing real after tax interest rates (which could decrease saving), or making preferred forms of saving, such as superannuation, more readily available. Both these have been tried in Australia recently, and neither has shown much evidence of success. In short, it is difficult for a government to engineer a sustained switch away from expenditure.

If Australia does have trading problems, the emphasis on competitiveness and industry level changes that are supposed to improve it are not only misplaced but also seriously counter-productive. It serves to deflect attention from the cause of the problems, and from the ways addressing them. In fact, achieving expenditure changes in particular difficult, in theory and in practice - far more so than achieving improved productively and export performance in particular industries. Effort is being directed towards addressing the easy, though irrelevant issue, at the expense of addressing the more difficult, yet fundamental, problem.

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FIG. 1

Competitiveness

\[ \frac{P_H}{P_F} \]

Supply of, Demand For Goods and Services

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