



Prevention is the best cure: having a fit and agile economy will ward off Dutch disease

When one sector booms leaving others languishing, productivity rather than protectionism will keep the whole healthy



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AS the new vaccinations arrive this year to ward off the latest exotic flu strains, we are reminded that the best defence against the virus is to maintain your body in fit and supple shape. So it is with the Australian economy, as we seek to resist Dutch disease.

No it's not something you pick up if you misbehave in Amsterdam. Dutch disease is an economic concept.

When large reservoirs of natural gas were discovered in Holland in the 1960s, their development caused the local currency to appreciate, making the non-resource Dutch industries uncompetitive. In Australia, ANU economics professor Bob Gregory identified the same forces at play from the expansion of our mining industries, warning in 1976 of the burdens it would place on manufacturing and the other non-mining industries.

Whether it's called the Gregory effect or Dutch disease, the phenomenon of the present China-fuelled mining boom pushing up the Australian dollar is creating policy challenges for the Australian Government.

The big question is: should the Government treat Dutch disease by protecting non-mining industries from competition, or should it fight off the disease by keeping the economy fit and agile?

Before the debate on prevention-versus-cure begins, it's worth examining how virulent Dutch disease becomes when it is contracted. Not all non-mining industries suffer. Construction does well, since it builds the mines and infrastructure needed to dig up the minerals for export to China. Other service industries connected with mining, such as engineering and finance, also thrive. So, too, can mineral processing.

Most vulnerable to Dutch disease are sophisticated manufacturing industries that are forced to compete with the giant factories of China at an uncompetitive exchange rate. No wonder our car industry is under pressure. Inbound tourism, too, is feeling the pinch.

Traditional treatments of Dutch disease include the basic protective devices of tariffs and import restrictions. The idea is that, by making the competition from imports more expensive, Australian manufacturing and service industries will survive the disease until the mining boom is over, the exchange rate falls and they regain their competitiveness.

These days the traditional remedies are out of fashion, but it hasn't stopped new remedies being proposed that are no less protectionist. Government grants and tax breaks for struggling industries sound more modern and respectable but, beneath the sugar coating, are little different in effect from the traditional tariff remedies. They do nothing to ward off the disease. Rather, they are a palliative, little more than pain relief with the side-effect of inflicting new pain elsewhere in the system.

As with all ailments, the best cure is prevention. Maintaining an open, competitive economy free of constrictions is the most effective response to Dutch disease.

Non-resource industries are best placed to deal with an appreciating currency if they are not riddled with regulatory impediments; blockages in the system make it more vulnerable. Yet, as the Business Council of Australia laments, the last decade has been one of creeping re-regulation of Australian business. Australia ranks last in the OECD for the harmonisation of service industry regulations across internal borders. Little wonder that by 2007 productivity growth had not just slowed from the boom period of the late 1990s, it hit rock-bottom zero. Eight out of the 11 industries with poor productivity growth this decade are service industries.

Australia needs a new program of productivity-raising economic reforms. Regulatory reform can remove impediments to the seamless flow of capital, labour and skills across state boundaries into their most productive uses. Beyond reforming business regulation, the modern sources of productivity growth are education, innovation and wise

investment in infrastructure. They constitute the four pillars of the Rudd Government's productivity-raising reform program.

As recognised by former US Federal Reserve chairman Alan Greenspan, creativity is at the centre of modern productivity growth. Investing in the talents and creativity of the Australian people is not only good social policy, it lies at the heart of good economic policy. A highly educated, creative workforce takes change in its stride, gliding from one job to another and creating new jobs in the expanding parts of the economy.

Manufactured goods and services that embody large doses of skills and new ideas can compete at home and abroad despite a strong currency.

In the midst of a mining boom, with non-mining industries under pressure from a strong currency, the test of any public policy proposal should be: does it encourage or impede the flow of capital, labour and skills into their most productive uses? Policies that encourage these flows should be supported; those that impede them should be rejected. Our future prosperity depends on it.

Craig Emerson is the Minister for Small Business, Independent Contractors and the Service Economy and Minister Assisting on Deregulation in the Rudd Government. This is written as a contribution to the New Agenda for Prosperity conference beginning in Melbourne today.

