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Comment 2 on 'Booming sector economics' by Freebairn

Andrew Stoeckel[†]

John Freebairn reviews the economics of a series of major economic events shaping the fortunes of a commodity exporter like Australia – the most recent, and biggest event in our history (still unfolding) being the mining boom over the last decade.

Freebairn traces the developments in theory and measurement of the economic effects of a boom – all reasonably well understood, at least from a theoretical point of view. He highlights that the cause of a boom matters enormously for the effects, whether from a supply-side shock such as new technology (the case of LNG), or a demand-side shock, such as China's booming economy and massive construction phase (the case of iron ore). The dynamics are also important: there is an initial price- and profit-boosting phase, this stimulates a subsequent investment phase and finally there is an increased production phase from the extra investment. So the mobility of labour and capital, the ownership and financing of the investment, expectations, the policy responses to changing wages, inflation, interest rates and budgets all matter for estimating the effects of the boom.

Freebairn mentions the 'resource curse', but, for space limitations, does not delve into this extensive literature. That is a pity as there is an important but subtle aspect from this literature on the 'resource curse', namely that, in Australia, a wide understanding of the economics behind a booming sector has prevented poor policies being introduced while 'rents' are booming.

Equally, it has been poor policies introduced during subsequent commodity price downturns that have harmed the fortunes of other countries. While there has been a tendency to some of this thinking in Australia, commonsense has prevailed. For example, well after the price of iron ore collapsed from its peak in 2011, there were calls for 'stabilisation' of the price but correctly resisted (Stoeckel 2015). It is poor policies from rent-seeking that really lies behind the 'resource curse' that has afflicted so many other resource-rich countries. The best counter to problems of poor political economy is widespread understanding of the economic effects and choices before the nation.

[†] Andrew Stoeckel (email: abstoeckel@gmail.com) is a Visiting Fellow at the Australian National University.

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Quantifying booming sector economic effects means comparing the observed with the unobserved 'what would have been' counterfactual. The best way to do this is with a model. The 'state of the art' is with a dynamic model that, besides well-known price and income responses, incorporates all other linkages in the economy, endogenous capital flows, factor markets (and their imperfections), endogenous policy responses (both money and fiscal), foreign ownership and more.

One of the best such models is the Aus-M model as used in some research by the Reserve Bank of Australia, to which Freebairn refers (Tulip 2014). Some main findings are that the recent mining boom lifted household incomes by 13 per cent, the real exchange rate appreciated by nearly 40 per cent above baseline and agriculture was the sector most disadvantaged.

Those results are from a single-country model where the main driver is China's economic boom. But China's boom changed many things globally. It lifted all other commodity prices for other countries like Brazil, and it changed world wage rates, interest rates and more. These changes in turn affected Australia, so a case could be mounted that a dynamic global model should be used to estimate the counterfactual, for example the G-Cubed model (McKibbin *et al.* 2014).

A potential omission from the counterfactual is the jump in Australia's savings rate during the boom due to the Global Financial Crisis. One extraordinary feature of the recent mining boom was the accompanying investment boom which had to be financed. If domestic savings are low, there has to be extra capital inflow which necessitates deterioration in the current account and an appreciation of the real exchange rate. The jump in Australia's savings rate brought about by fears stemming from the GFC lowered the capital inflow required to finance the boom. It might be that the above results, especially the real exchange rate effects, are overstated – a point worth exploring. It might just be, given events, 'that the GFC saved Australia'!

References

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