

Minerals Council of Australia

Clouds in the silver lining?

The two speed economy and Dutch
disease

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Executive Summary

The economic effects of mining booms have been discussed at length recently. Terms such as “two speed economy” and “Dutch disease” have been used to describe some of the possible negative economic effects, and imply that higher export values, improvements in our terms of trade, and higher average purchasing power are somehow unhealthy.

These concerns are misplaced. Unease about the two speed economy and industries or regions being “left behind” ignores the fact that growth across sectors and regions has rarely (if ever) been uniform in Australia or indeed, in any market economy.

In a modern, dynamic, growing economy, there are always sectors that are expanding and contracting as demand and supply conditions change and prices adjust. Australia does not have a “two-speed economy”; it has thousands of industries operating at different speeds, with price and resource adjustments taking place constantly.

This paper shows there is nothing unusual about regional growth disparities in Australia. Economic growth in Australia has rarely, if ever, been uniform between States and Territories over the last twenty years. Indeed, current disparities are low by historical standards.

In addition, there is nothing particularly unusual about different sectors growing at different rates in Australia. Indeed, this seems to be the rule rather than the exception.

Debate on the so-called Dutch disease also appears somewhat confused. The Dutch disease hypothesis in fact predicts that in response to a mining boom, industries in the non-traded sector (for example, services, which comprise around 70 per cent of the economy’s gross value added) are likely to expand as well. There is nothing in the Dutch disease story which says that the mining boom necessarily reduces wages, slows overall economic growth or reduces income. Indeed, the increase in minerals prices boosts the nation’s overall income, increases growth and is likely to raise wages.

The Two Speed Economy: Exception or Rule?

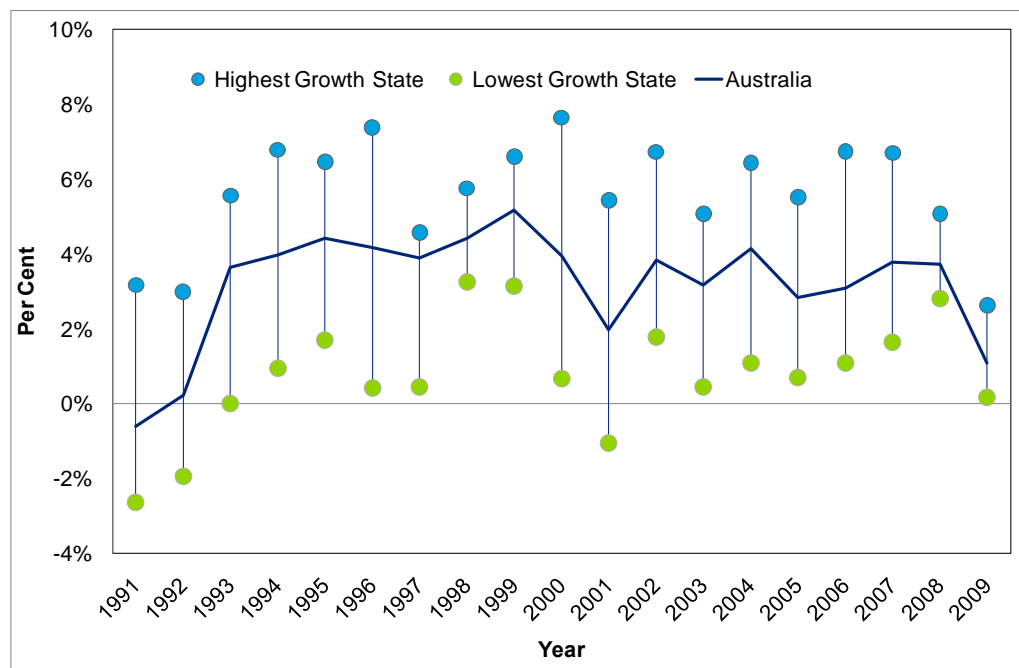
Australia's merchandise export performance has long been dominated by exports of minerals commodities. As a result, the mining sector makes a major direct and indirect contribution to the Australian economy.

Recently there has been a great deal of discussion of the economic effects of the mining boom in Australia. For example, Statement 4 of Budget Paper Number 1 – which is traditionally the economic thought piece in the Budget – this year focuses on the longer term structural issues arising from the mining boom and the appropriate policy response.

One argument that has been put forward that focuses on negative consequences of mining booms is the “two speed economy”. Part of this argument is in terms of regional growth disparities, and points out that during mining booms, different Australian States and Territories grow at different rates. The implication seems to be that this is somehow an abnormal or unusual situation.

Figure 1 below, however, shows that there is nothing unusual about regional growth disparities in Australia. The figure plots the spread of growth rates in Gross State Product in Australia: the economic performance of Australia's best performing State or Territory each year, along with the worst. The data shows that economic growth in Australia has rarely, if ever, been uniform between States and Territories over the last twenty years. Further, recent disparities are low by historical standards.

Figure 1: Dispersion of Real Economic Growth Rates in Australia by State/Territory, 1990-91 to 2008-09

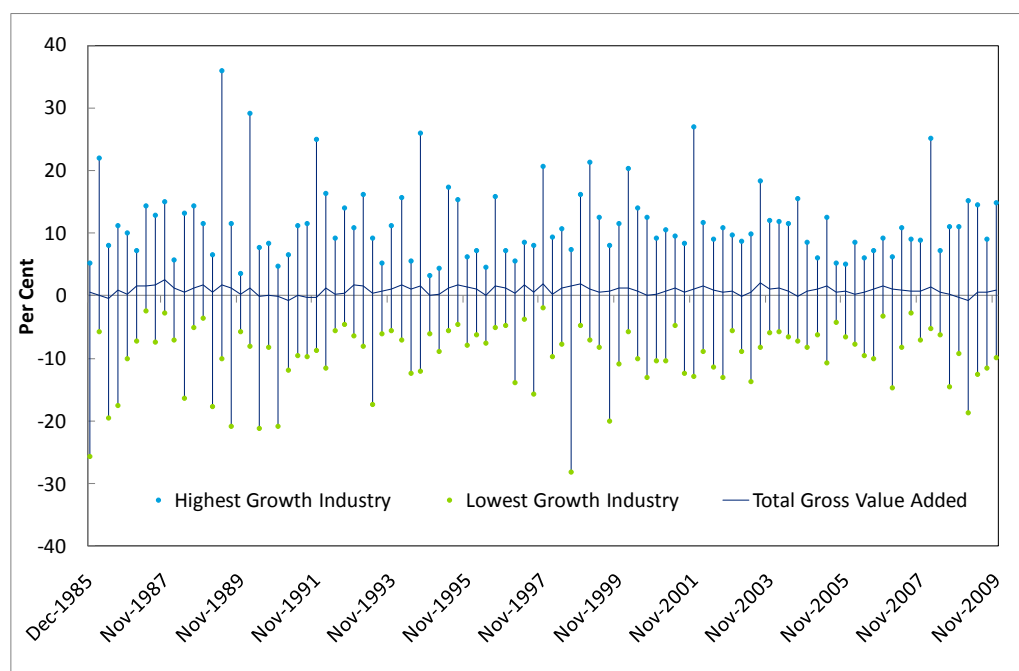


Source: Australian Bureau of Statistics, Cat. No. 5220.0, Australian National Accounts: State Accounts, 2008-09; Deloitte Analysis

A second dimension to the “two-speed economy” argument is in terms of sectoral growth discrepancies. Again, the story here seems to be that during mining booms there are large and unusual discrepancies between growth rates of economic activity in different sectors.

Figure 2 below plots the spread of growth rates in Australia - the economic performance of Australia’s best performing sector each quarter, along with the worst – in terms of growth in gross value added. Once again, the data shows that economic growth in Australia has rarely been uniform across sectors. In other words, there is nothing particularly unusual about intersectoral growth disparities in Australia. Further, current disparities are not especially high.

Figure 2: Dispersion of Economic Growth Rates in Australia by Industry, 1990-91 to 2008-09



Source: Australian Bureau of Statistics, Cat. No. 5206.0, Australian National Accounts; Deloitte Analysis

Both Figures 1 and 2 show that there is nothing particularly unusual about economic growth rates differing between different regions or sectors of the same economy. Indeed, dispersion of growth rates between states and industries seems to be the rule rather than the exception in Australia, and current disparities are not unusual.

Economic Growth: Mushrooms Versus Yeast

In a modern, dynamic, growing economy, there are always sectors that are expanding and contracting as demand and supply conditions change and prices adjust. In reality, Australia does not have a “two-speed economy”; it has thousands of industries operating at different speeds, with price and resource adjustments taking place constantly.

Economic growth is driven by the gains from international trade (and responding to changes in international prices), technical improvements, and real cost reductions at the firm level (which can occur in many different ways). The view that economic development and macroeconomic growth should always be uniformly distributed across the economy makes little economic sense, because the sources of economic growth are never uniform. Non-uniform rates of expansion and contraction are desirable and in fact necessary for economic progress and are part and parcel of the process of economic growth and sustained improvements in living standards.

A rising standard of living for society as a whole requires that scarce resources move from less valuable to more valuable uses. Whether it is rising world prices or technological advance, some industries advance, and others become obsolete. Indeed, that is how growth occurs in modern economies. Some industries expand, and some contract. Within individual industries - even rapidly growing industries - some firms prosper and others shrink. The key to dealing with these economic changes is to have economic institutions that permit adjustments to occur relatively smoothly, and at low cost. Indeed, such institutions – such as flexible labour, product and capital markets and a flexible exchange rate – have been a key driver of Australia’s sustained economic performance over the last two decades.

As the eminent economist Arnold Harberger pointed out in his 1998 Presidential Address to the American Economic Association, growth of the economy is analogous to the growth of mushrooms, not yeast:

*“Yeast causes bread to expand very evenly, like a balloon being filled with air, while mushrooms have the habit of popping up, almost overnight in a fashion that is not easy to predict. ... The 1920’s were a decade of cars and rubber tires, the 1930’s the decade of refrigerators, the 1940’s that of pharmaceuticals(especially antibiotics), and the 1950’s that of television, with telecommunications and computers taking over in recent decades.”*¹

In any single period, a small fraction of industries accounts for most of the economy’s productivity growth, with the other industries containing both winners and losers which cancel out. Talk of a ‘two speed economy’ or industries being ‘left behind’ focus on particular groups, industries or regions that do not share in the general prosperity. But the general prosperity itself depends on transferring resources from where they are less productive to where they are more productive. That is, industries that are growing and industries that are contracting are part of the same process. Lamenting the role that high growth sectors play in drawing resources away from low growth sectors is like the reverse of picking winners: it is picking on winners.

Dutch Disease

“Dutch disease” is a term that is used to describe the following phenomenon: an increase in world minerals prices increases income, and this increase in income leads to increased demand for both traded goods (imports and domestically produced exportable goods) and non-traded goods (goods that are not exported and do not compete with imports – for example, services).

This increase in demand leads to an expansion of the non-traded goods sector, and imports rise and exports fall. The higher demand drives up the relative price of non-traded goods, leading to a real appreciation of the currency. The domestic traded goods sector

¹ Harberger, A. (1998) “A Vision of the Growth Process”, *American Economic Review*, 88(1): 1-32, page 4.

(exportables and import competing goods) contracts as resources flow to the non-traded sector. This effect comprises what is termed the *spending* or *demand side* effect of the mining boom.

In addition, the mining boom draws productive resources out of both the traded and non-traded goods sectors towards the mining sector. This is the *supply side* or *resource movement* effect. The term “Dutch disease” is used to describe the overall contraction of the domestic traded goods sector as a result of these two effects.

It is important to note, however, that there is nothing in the Dutch disease story which says that the mining boom reduces wages, slows overall economic growth or reduces income. Indeed, the increase in minerals prices boosts the nation’s income and growth. Moreover, the Dutch disease story predicts that the non-traded goods sector - which in Australia consists mostly of services, which comprise around 70 per cent of the economy’s gross value added² – is likely to expand as a result of the demand side effect of the mining boom, not contract. The expansion in the labour intensive non-traded sector and increased foreign investment is likely to increase wages.

The supply side effect of the boom on the movement of resources within the economy is likely to be relatively small, as mining is capital intensive and its increased demand for resources would mainly be met through increased foreign capital inflow (which would reinforce the increased demand for non-traded goods).

The extent of the real exchange rate appreciation associated with the mining boom is directly affected by the ease with which resources flow into mining and into other activities whose expansion the boom encourages. For the dominant demand side effects of the mining boom, the greater the responsiveness of supply of resources to the expanding sectors, the less the exchange rate appreciation required for the adjustment process to occur and the smaller the effect on prices and income distribution. That is, the greater the inter-sectoral output adjustment, the smaller the effects on income distribution. This makes it vital that blockages to structural adjustment are identified and removed.

The supply side effect – the movement of resources and labour out of other sectors into the mining sector - is necessary if living standards are to improve further, over and above the initial income improvement from the demand side effect. New technologies, new industries and growing industries can only get the resources they need by paying resources a sufficiently high amount to move them away from other parts of the economy. The efficient allocation of scarce resources means that some industries will give up their ability to use those resources so that others gain the ability to use them more profitably.

Conclusion

There is a straightforward (albeit highly undesirable) way to avoid the two speed economy: slow down the faster sectors to discourage resources from moving between sectors.

But in an ever-changing economy with new and more productive technologies emerging and more efficient methods of organisation being devised, to keep workers permanently employed where they are already employed is to force society to forego the economic benefits of such new developments.

² The Australian Bureau of Statistics classifies service industries as encompassing the following activities: wholesale trade; retail trade; accommodation and food services; information, media and telecommunications; financial and insurance services; rental, hiring and real estate services; professional, scientific and technical services; administrative and support services; public administration and safety; education and training; health care and social assistance; arts and recreation services; and other services. See ABS (2008) *Yearbook Australia*, page 589.

The transfer of resources to more valuable uses must occur if living standards are to improve. Unless workers are to be ordered from one industry, region or occupation to another, economic incentives and constraints must accomplish these transfers in a market economy: using the price system, profits and losses.

The experience of the last 25 years shows that Australia's general prosperity depends on the ability of resources to move from relatively low valued uses to where they more productive and more valuable. Concerns about the negative effects of the growth of the mining sector – which by definition means that in *relative* (but not necessarily in absolute terms), some other sectors must contract – are misplaced.