# The Changing Structure of the Australian Economy and Monetary Policy


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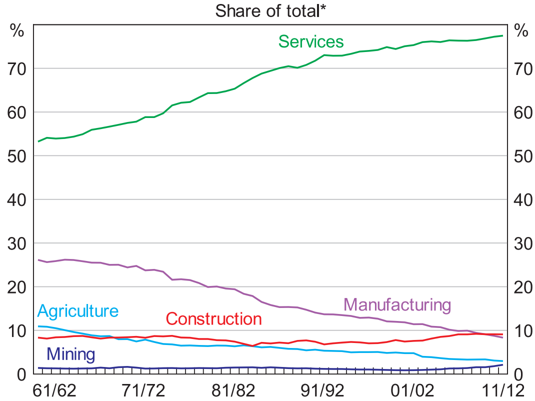
I would like to begin by thanking the AiGroup for the invitation to once again speak at the annual Economic Forum. When I spoke at last year's Forum, the title of my remarks was 'Changing Relative Prices and the Structure of the Australian Economy'. Today, I would like to revisit this topic of structural change, first talking about some of the adjustments that are taking place within the Australian economy and then, second, discussing some of the implications of these adjustments for monetary policy.

## Structural Change in the Australian Economy

Structural change is, of course, something that is not new. It is one of the ongoing features of all economies. Over the past half a century, one of the most obvious changes has been the growth of the services sector, which has accounted for a steadily increasing share of both output and employment. In 1960, for example, a little over 50 per cent of the workforce in Australia was employed in the services sector. Today, the figure is over 75 per cent (Graph 1). Conversely, the shares of manufacturing and agriculture have steadily declined.

These trends have been driven by a range of factors, but three stand out. The first is that the demand for services has increased faster than the demand for goods as average incomes have risen. The second is that most services are produced domestically rather than imported. And the third is that the rate of labour productivity growth in the production of services is lower than that in the production of goods. Not surprisingly, these same general influences have also been at work in all other advanced economies.

**Graph 1**
**Employment by Industry**
Share of total*




* Estimate for 2011/12
Sources: ABS; RBA; Withers, Endres and Perry (1985)

Beyond these long-term influences, the structure of the Australian economy is currently also being affected by a number of other factors that are more unusual in nature. I would like to take a few minutes to talk about two of these.

### The mining boom and the exchange rate

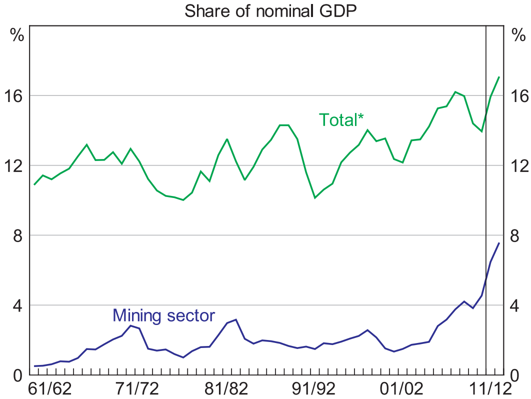
The first is the mining boom and the high exchange rate.

As is well known, Australia is currently experiencing, on the one hand, a once-in-a-century terms of trade and investment boom and, on the other, a very high exchange rate. These events are, of course, related to one another and are really different sides of the same coin.

It is worth noting that these developments have not led to unusually large shifts in the industry structure of employment, and they are unlikely to do so. While employment in the mining sector has increased by around 70 000 people, or 40 per cent, over the past couple of years, its share of total employment is still low and the mining boom will not change the fact that the vast bulk of Australians work in the services sector. Instead, due to the capital-intensive nature of mining, it is in the investment figures where the evidence of structural change is clearest. Over the next few years, mining-sector investment will reach new highs as a share of GDP, and is likely to account for around 40 per cent of total business investment (Graph 2). Structural change is also clearly evident in the export numbers, with resources now accounting for around 60 per cent of total exports, up from 35 per cent a decade ago.

This boom in the mining sector and the terms of trade is having positive spillover effects to a number of areas of the economy, including parts of the services sector. It has delivered a very substantial increase in Australia's real income and this increase has boosted spending. But the accompanying high exchange rate is also having a contractionary effect on a number of sectors of the economy.

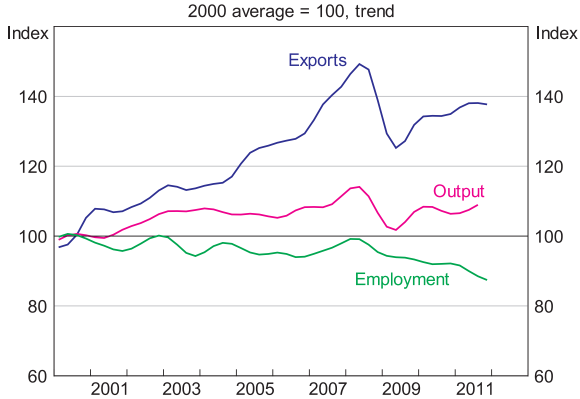
**Graph 2**
**Business Investment**
Share of nominal GDP




* Excluding livestock and orchards
Sources: ABS; RBA

The manufacturing sector is clearly one of these. Over the past decade there has been little growth in manufacturing output and the level of employment has declined, particularly over the past couple of years (Graph 3). Exports of manufactured goods also remain below the level reached in 2008. This stands in contrast to the volume of global trade which has regained its earlier peak.

**Graph 3**
**Manufacturing Industry**
2000 average = 100, trend

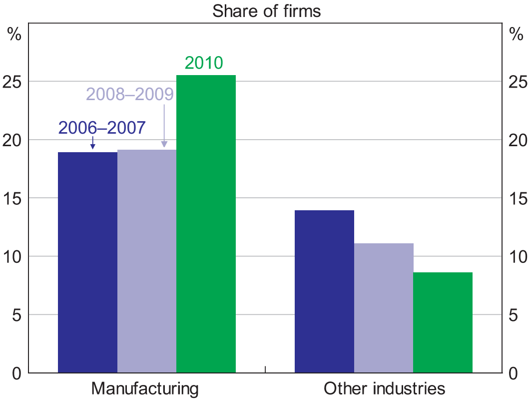



Sources: ABS; RBA

Notwithstanding these trends, manufacturing still has an important role to play in the Australian economy. It employs around 950 000 people and accounts for 9 per cent of output. This role is, however, changing. Realistically, Australia cannot hope to be a large-scale producer of relatively standardised, plain-vanilla manufactured goods for the world market. But what we can be is a supplier of manufactured goods that build on our comparative advantages: our educated workforce; our ability to design and manufacture specialised equipment; our reputation for high-quality food; our research and development skills; and our expertise in mining-related equipment.

Inevitably, the high exchange rate means that the manufacturing industry has little choice but to move up the value-added chain in order to compete. This is, of course, a lot easier to say than to do. It means difficult changes for many firms and those who work for them. It also means ongoing investment in human capital and the latest machinery and equipment and constant attention to improving productivity. One piece of evidence that things are moving in this direction is in the ABS business characteristics survey, which asks firms a series of questions about innovation. In this survey the manufacturing sector clearly stands out as one where firms are actively reviewing their business practices and, over recent times, they have been doing this more frequently (Graph 4). No doubt, more of this will be required over the years ahead.

**Graph 4**
**New Operational Processes**



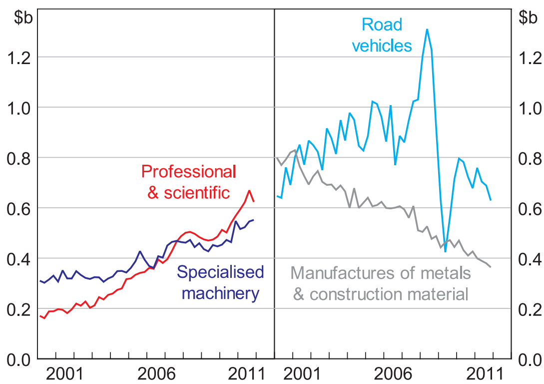
Sources: ABS; RBA

The changes within manufacturing are also evident in the export figures. While, in aggregate, exports of manufactured goods are little changed from their level in 2007, there has been strong growth in some categories including specialised industrial machinery and professional and scientific instruments (Graph 5). These are both areas where human capital and specialised skills are important. In contrast, exports of motor vehicles and construction materials are well down on their earlier levels.

Another area of the economy where the high exchange rate is having a noticeable effect is the tourism sector. As is the case in the manufacturing sector though, the story is not uniform across the industry. Indeed, the structural change that is occurring in the economy is taking place not just across industries, but within industries as well.

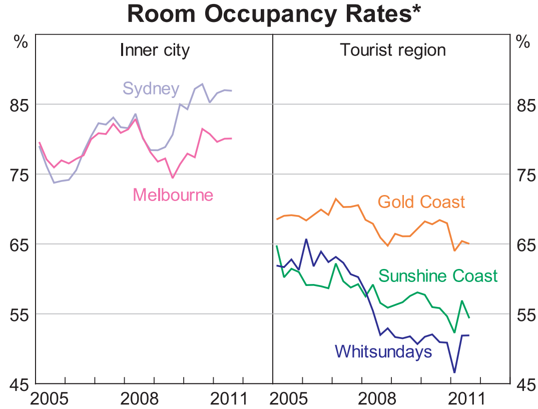
The boost to real incomes from the mining boom has clearly increased Australians' ability to travel. However, the high dollar has contributed to a decline in travel to the traditional domestic holiday destinations, with Australians travelling overseas in ever increasing numbers. This has created quite difficult conditions for parts of the industry with, for example, room occupancy rates along the Queensland coast having fallen over recent years (Graph 6). In contrast, conditions are noticeably stronger in the accommodation sectors in some of the large cities which are benefiting from an increase in business travel and an apparent shift in preferences by overseas tourists for city-based experiences. In Sydney, for example, room occupancy rates are at quite high levels.

**Graph 5**
**Manufactured Export Volumes***



* 2009/10 prices; seasonally adjusted by the RBA
Sources: ABS; RBA

**Graph 6**
**Room Occupancy Rates***



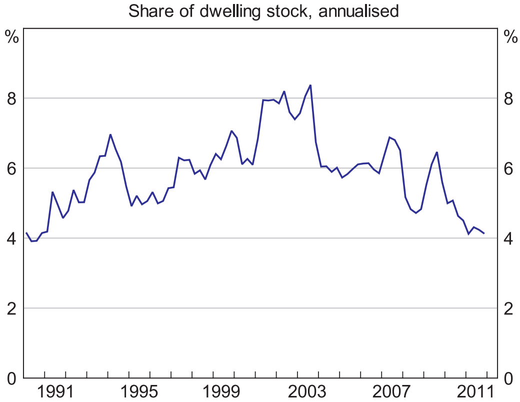
* Seasonally adjusted by the RBA
Sources: ABS; RBA

## Household spending and borrowing

A second general factor that has been driving changes in the structure of our economy is the adjustment in household borrowing and spending behaviour. The RBA has talked frequently about this issue over recent years, and the flow-on effects are evident in various parts of the economy.

One of these is the property market. In the early 2000s, when the property boom was in full swing and investors were busy buying properties to rent out, around 1 in 12 dwellings in Australia was changing hands each year (Graph 7). Today, the rate of turnover is only about half of this, with around 1 in 25 dwellings changing hands last year. This lower rate of turnover has contributed to weak employment growth in the real estate sector over recent years, after many years of strong growth.

**Graph 7**
**National Dwelling Turnover Rate**
Share of dwelling stock, annualised

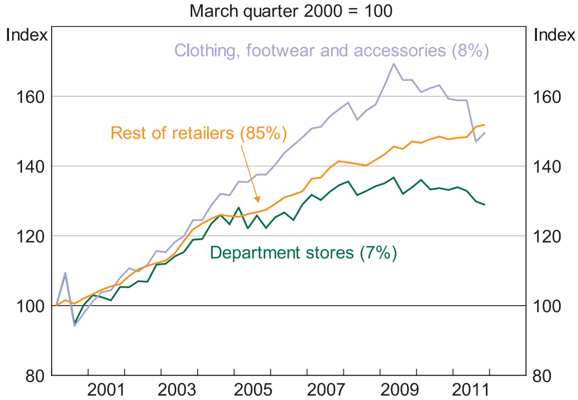


Sources: ABS; RBA; RP Data-Rismark

The change in household behaviour is also affecting the financial sector. Financial institutions are having to learn to live with much lower growth in their balance sheets than was the case over recent decades. This is leading to changes in business practices, and there has been a slight decline in employment in the banking sector over recent years. Conversely, there has been strong growth in employment in the provision of financial advice, partly due to the steady inflows into superannuation funds.

A third area where the change in household behaviour is having a structural effect is in the retail industry. While I talked earlier about the increase in the consumption of services, there are also significant changes taking place within the retail industry. Perhaps the most striking of these is the decline in sales at department stores and clothing and footwear retailers (Graph 8). Indeed, since early 2009, the volume of sales in these stores has declined by around 6 per cent. This stands in contrast to relatively steady growth in the volume of sales in the rest of the retail industry.

**Graph 8**
**Retail Sales Volumes**
March quarter 2000 = 100



Sources: ABS; RBA

There are a variety of explanations for these divergent trends, but there is no doubt that the greater price transparency brought about by the internet is part of the story. Many Australians have worked out that the prices charged by domestic retailers for certain goods are higher than those charged by overseas online retailers. Whether this price difference is because of higher domestic costs or because foreign manufacturers and wholesalers are selling into the Australian market at higher prices, Australian consumers have responded by increasingly going online. As in the other areas of the economy that I have talked about, this is causing a rethinking of business models and retailers are having to make changes to the way they run their businesses.

So, putting all this together, the overall picture is a pretty complicated one. How you view the economy depends very much on your perspective. Even within specific industries, experience can vary widely from firm to firm. To date though, while there are obviously large effects on individual businesses and people, the various cross currents have balanced out reasonably well from a macroeconomic perspective: GDP growth is close to trend, inflation is consistent with the target, interest rates are around average and unemployment is low.

These macroeconomic outcomes are much better than those being recorded in other advanced economies. However, the various cross currents are having an unsettling effect on parts of the community, with many people focusing on the costs of structural change. These costs are undoubtedly real and they are not borne evenly across the country. However, the benefits of structural change are also real and, over time, as we have seen in the past, these benefits do get spread widely across the population. If Australia is to take advantage of the opportunities that lie ahead, the structure of the economy must continue to evolve and we need to ensure that our labour and capital are used where the returns are highest.

## Implications for Monetary Policy

I would now like to turn to some of the implications of the ongoing structural change for monetary policy. There are four closely related observations that I would like to make.

The first is that structural change adds to the difficulty of assessing the balance between supply and demand in the economy. Given the historically unusual nature of the forces affecting the economy, history provides only limited guidance as to the magnitude of their ultimate effects. This is one reason why the Reserve Bank is devoting considerable resources to understanding these forces, including by frequently talking to businesses at the forefront of this structural adjustment.

The second observation is that the main role for monetary policy is to keep inflation low and stable. The current list of economic uncertainties is long enough without adding uncertainty about the general level of prices to the list. The task for monetary policy is to ensure stability in the overall economy so that difficult decisions at the firm and industry level are not further complicated by macroeconomic instability.

In undertaking this task, the Bank needs to understand the forces driving structural change, and we are working hard on this. But it is important to recognise that the RBA can do little to affect these forces. As I said at last year's Forum, the emergence of Asia as a major force in the global economy has shifted world relative prices and this underlies many of the changes that are occurring in the Australian economy. This shift in relative prices is not something that monetary policy in Australia can influence. It is driven by global developments and is causing adjustments not just in Australia, but around the world. Monetary policy in Australia can, however, help in our own adjustment process by keeping the overall economy on an even keel.

The third observation is that the flexibility of the economy is important when structural change is taking place. To the extent that there are significant impediments to resources moving between industries and/or parts of the country, these impediments are likely to worsen the short-run trade-off between inflation and unemployment. While the degree of flexibility in the economy is determined by factors other than monetary policy, it can have an important bearing on overall macroeconomic outcomes.

And the final observation is more directly about the link between monetary policy and the exchange rate. It has been argued in some quarters that Australia's high interest rates by current world standards have put upward pressure on the exchange rate, and thus have added to the pressures being experienced in some industries. Some who have argued this see part of the solution as being a material easing of monetary policy.

The difficulty with this argument is that, at least on the evidence to date, something like the current combination of exchange rates and interest rates appears to be what is needed to maintain overall macroeconomic stability. The high exchange rate and the high interest rates relative to the rest of the world are both being driven by the fact that Australia is a major beneficiary of the change in world relative prices. They are both playing an important role in preserving overall macroeconomic stability, something which has proved very difficult to achieve in previous resources booms, which typically ended in a bout of serious inflation with significant costs to the community.

Of course, it is possible for exchange rates to overshoot. Australia is seen by foreign investors, including central banks and sovereign wealth funds, as an attractive destination for investment, and we need to be alert to the possibility that portfolio flows could push up the exchange rate too far. While the evidence of the past 30 years is that movements in the exchange rate have been an important stabilising force for the Australian economy, the unusual nature of the current forces means that we need to watch things closely. An important indicator here is the labour market with the unemployment rate having been in the 5 to 5¼ per cent range over the past year. If the unemployment rate were to rise persistently, it might suggest that the contractionary effect of the high exchange rate was more than offsetting the expansionary effect of the investment boom and the terms of trade. If this were to turn out to be the case, monetary policy would have the flexibility to respond provided the inflation outlook remained benign.

## Conclusion

To summarise, the challenge that we Australians face is to make the best of the fundamental changes that are taking place in the global economy. As a country rich in natural resources, we are well placed to benefit from this change. But if we are to take advantage of this opportunity, the structure of the economy must continue to evolve. Labour and capital will continue to shift to the resources sector. Industries affected by the high exchange rate will need to find ways of moving up the valued-added chain. And parts of the service sector will need to continue their adjustment to the changes in household spending and borrowing.

These adjustments are difficult, but if they are not allowed to occur, as a nation we will have given up the potential benefits that the changes in the world economy are making possible. Public policy can help in the adjustment process by promoting flexibility in the economy and by reducing some of the costs of change for individuals and communities. It can also help manage some of the new risks arising from these global developments. Monetary policy can help the adjustment by keeping inflation under control and maintaining stability in the overall economy. Our judgement is that the current setting of monetary policy is consistent with this, with the Board keeping the cash rate unchanged at 4.25 per cent at its meeting yesterday.

I would like to thank you very much for your time this morning, and I am happy to answer questions.

## Reference

**Withers G, T Endres and L Perry (1985),** 'Australian Historical Statistics: Labour Statistics', Australian National University Source Papers in Economic History No 7.