Next year there will be some signposts which a prudent investor should watch for.

What happens in the rest of the world will be important. We sell a small number of resource-based exports. Among these grains, sugar, coal, alumina and copper have prices well below trend lines. Wool, red meat, and iron ore are better but not brilliant. Only gold looks good. Our terms of trade, that is the ratio of prices paid to prices received, have deteriorated quite badly.

Several commentators believe the world will enjoy a recovery during next year. Reasons include the run down of some of the high stocks of manufactured goods, the end of some of the worst fears of national default (although Mexico and some others still look risky to me.) and the second half of the Presidential term in the United States. The US economy is not so burdened with unions, public sector monopolies and regulations as Europe and, in spite of its foreign debt problem, would still respond to a Keynesian stimulus in time to help the Republican candidate in 1988.

Because Japan’s economy is intrinsically strong and it will benefit from US growth, it and the North Western Pacific nations would lead a recovery.

Another scenario is that following the Democrat Senate victory, the United States will retreat into protectionism and Europe and the Japanese will retaliate with more protection. Protectionism, particularly the United States Smoot-Hauley act, was a prime cause of the great depression and an ‘excuse’ for Japanese militarism. A recession caused by tit-for-tat protection would cause further collapse of resources trade. This would hit Australia and cause a few third world nations to default to US banks. That would cause a minor banking crisis, although no-one thinks central banks will allow wholesale door shutting. Bingo -- another depression.

The two scenes are so different as to mock forecasting! The cautious investor should watch the US Congress and Japan’s reaction to it.

Commodity prices are a signpost. If Australia were to suffer further set-back to its terms of trade our serious debt problem would become critical. Even if the world recovers Australia can not be in the vanguard. We suffer from deeply rooted domestic problems.

Most of this century Australian imports have been greater than exports. The difference has been capital invested to earn more than enough to service the resultant debt—like an expanding business. But since 1974 loans have been used to increase living standards—like a family living beyond its means.
The situation is getting out of hand. Measure everything in Australian dollars: as the Australian dollar devalues our exports, imports and the gap between them increase by the same proportion. So does the cost of servicing debts. If Australian costs do not also rise proportionately, Australian goods and services become more competitive, reducing the volume of imports and increasing exports, closing the gap between the two—the heralded J curve effect.

But, (still thinking in Ausie dollars) the new competitiveness must compensate for the initial increase to the trade deficit and the increased debt service obligations—the short end of the J. By indexing wages, and hence costs, the Arbitration Commission has not allowed the long arm of the J to materialise.

In 1982 Fraser stimulated the economy. (To combat the drought; there just happened to be an election.) The new government continued the dangerous policy, boasting of the growth achieved thereby, and relying on ‘the accord’ to prevent expenditure running ahead of production. In spite, or because of the accord, since 1983 Gross National Expenditure has outrun GDP; the difference being foreign borrowings. Living standards must fall until we have paid for the excesses of the past four years. Members of some unions may avoid sharing the restraint but trade union members as a whole cannot.

Average wages will rise by more than the average of minimum awards. Should minimum awards rise by even the 2% which the government seems to find acceptable let alone the full indexation asked by the ACTU, wages share of what is left of GDP after debt service will rise and investment will be further squeezed. The play between the Government and the ACTU will affect the opportunity to invest profitably next year.

Governments faced with real wage settlements which have been too high for their economies to sustain have accommodated them by printing enough money for the workers and the investors. This has caused inflation to reduce real wages. But Australia does not have that option; our inflation is already four times our trading partners and we are bleeding on foreign account.

An unacceptable wage outcome would give investors the Memphis blues—that is scare the pants off them. An insufficient decrease in real wages is likely to further marke down our dollar. Money supply, with accompanying inflation, sufficient to accommodate it will make further devaluation a near certainty. To try to prevent a flight of capital real interest rates would be raised even further. Watch the labour market.

If Australia’s credit rating were to be further reduced a point would soon be reached where even equity investment in Australian companies would be outlawed for most foreign institutional investors.
The collapse of investment in mines, factories, machines and the like is most worrying for the long run. The housing sector has always taken too big a share of Australian investment. We are rapidly becoming the best housed economic basket case in the world. The government could improve this by copying Sri Lanka with a capital gains tax on housing and none on equity investment. Pigs might fly. Don't bother looking for anything sensible.

Public sector borrowing is another signpost. By borrowing much less governments could reduce the pressure on the capital market. Were it not for promised tax cuts the Commonwealth could easily budget a surplus but it won't. Prudent investors should watch how effectively the treasurer leans on the semi-government authorities and the State Governments, neither of which have ever been impressed by the need for restraint.

The one hope for economic recovery with minimal pain is a wholesale improvement in productivity. Australia has more artificial barriers to high productivity than almost any nation. All one need do is remove them. Prudent investors with an eye to the long future should see whether the government reduces protection, deregulates the labour market, prevents the excessive regulation of buildings, deregulates transport and much more. Most of the benefits of these 'supply side' changes take a few years but then they last for ever or until reversed by another government. A government that attends to them will convince the world that the A$ is worth holding after all.