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ON THE DRY SIDE 423

Of Debt and Protection

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The same Mr Keating who once told us that the 'scorched-earth' policies of the Coalition were unnecessary, now tells us that his recession is the recession we had to have. He was driven, I suspect reluctantly, to his change of heart by a very proper fear of too much foreign debt.

His was a momentous policy U turn. Not so long ago he was telling us that Australia's current-account deficits did not matter. They were, he said, purchasing the capital equipment that would, in due course, generate the necessary export income to service the growing external claims. Unfortunately this was not true, and Mr Keating came to see the distinct possibility that the deficits' legacy, and therefore his own, might be foreign debts that were unmanageable. Once he perceived the risk, not to have tried to stop the trend would have been irresponsible.

Labor's mistake is plain. When it came to office in 1983, Labor intended to adopt a fiscal and monetary stance that was more relaxed than that practiced by the Coalition. A current-account problem had, in these circumstances, been foreseen. Although there is room for great cynicism about the power it gave to the ACTU executive, the Accord, an incomes policy, was intended primarily to avoid the balance of payments and inflation consequences of relaxed fiscal and monetary policy. When it failed to meet these expectations, Mr Keating tightened fiscal policy. And, when that did not work, he tried to reduce consumption by squeezing credit---the very scorched-earth policy he had so roundly condemned. In the meantime, foreign debt had grown alarmingly.

Mr Keating's rhetoric at several points along the way is not excusable, but, given the initial error of relying on an incomes policy and given official expectations of that time and since, his subsequent reactions to the current-account deficit have been pretty much those of any Treasurer. In fairness it should be noted that he is not alone in his disappointment that an historically large Federal budget surplus and a pretty stinking recession have not done more to reduce imports. Being fair to the Treasurer's mistakes, however, does not tell us where to go from here. Even if the scorched earth does reduce the current account deficit, what will happen when recovery is attempted?

The links between Gross Domestic Product (GDP), the current account and foreign debt had already been explained by EPAC. However, at the Western Australian Summer School, I heard it done again rather nicely for a lay audience, by Professor Larry Sjaastad of Chicago University.

It is one thing, he says, for a young person whose income is expected to rise quite rapidly to incur heavy debts, it is another thing for a retiree whose income is static or declining in real terms. So it is with nations. So long as GDP is growing well, the ratio of the foreign debt to GDP will level off even with quite high current-account deficits. For instance, a continuous current-account deficit of 5% of GDP, with real economic growth of 3% of GDP, will see foreign indebtedness level off at a little over 70% of GDP. (Australia's net external claims are currently 35% of GDP, having grown from 5% in a mere decade.)

Long before the debt-to-GDP ratio levels off, however, each year's new borrowing and more, will be needed to pay for past borrowings. But, so long as the indebted nation does not face a war, a drought or a collapse in export prices, it could live with such debts---many third-world nations and a few first-world nations such as New Zealand do, albeit precariously. However, if real economic growth should decline below the assumed 3%, then the equation becomes really ugly. All of those public policies which depress economic growth, such as tariffs and centralised industrial relations, therefore, also prejudice the ability to service foreign debts.

Should the ability of a nation's people to borrow from abroad be seriously diminished, then they will have to reduce spending on themselves in order to pay the interest bills and, if lenders become reluctant to roll-over old debts, they must repay some principal as well. Professor Sjaastad sketched some models, some of which could be likened only to 'cold turkey'.

Let us put to one side the as yet not very likely circumstances that would require Australians to reduce their net foreign debts---i.e. run a current account surplus. Let us instead say that capital inflow must be reduced only to 2% of GDP over a space of 2 years. To achieve this we would have to reduce our spending, relative to GDP, by about A$10 billion over five quarters and by as much again over a longer period thereafter. What is more, all of that adjustment would need to be made in those goods and services that are traded internationally.

Blocking imports won't avoid the obvious pain. Import barriers don't much affect trade balances. Via the exchange rate mechanism, import barriers become taxes on exports. Thus, they affect the volume of trade, but do little to its balance. High tariff countries, such as Australia, not only have expensive goods, but they also trade a low proportion of their Gross Domestic Product. Australia trades about half that of most countries of comparable size and wealth.

High costs and a high dollar, both associated with high tariffs, mean that we cannot manufacture for export or add much value to our iron, wool, coal etc. In these circumstances, we can export only where our comparative advantage is greatest---that is, mainly from our resource-based industries.

The essential features of Sjaastad's paper are:

- that Australia's debt does matter (a $10 billion adjustment is, after all, about $2000 per household) and,
- if Australia is to trade its way out of high levels of debt, then Australians must cure themselves of their addiction to trade barriers.

Certainly, there is more to becoming internationally competitive than reducing tariffs---labour market reform, for instance---but if we don't reduce tariffs we cannot become competitive. Some people will not like the discipline involved in tariff reduction much better than they like Mr Keating's scorched-earth policy. It is, however, past time that these people admitted that the alternative to micro-economic reform in general, and tariff reduction in particular, is to suffer more-or-less permanently scorched earth.

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