

Foreign Debt Does Matter

John Hyde

In spite a yearly current account deficit of nearly \$18,000 million, an argument is gathering momentum in accademic circles to the effect that we should stop worrying about it. The argument is dangerous---particularly so in an election year. Already Mr Keating is vacillating. At one moment he tells us that living standards will have to fall. At another he tells us that the deficit is financing good hard investments and government policy is 'on track'.

The reason that current-account deficits matter is basically that deficits incur debts. The accademic economists say that if debts finance investments which generate enough income they are a good thing. That is undoubtedly so, but there are reasons to believe that our capacity to earn foreign exchange has not increased in proportion to the cost of servicing our foreign debts. Where, after all, is the improvement in productivity which the foreign investment has financed? So far, Australian productivity growth has been dismal.

I am reminded of farmers in the eastern parts of, Western Australia's wheatbelt. During several good seasons, economic growth had been excellent. Farm businesses expanded. Shiny new grain harvesters became the local status symbols. As well as these 'farm' investments, Mum got a new kitchen and the kids a swimming pool. Lifestyle was the 'in' word.

It was the time when the Eastern Wheatbelt spent and borrowed. To say that the rest of us were envious, while we made do with their cast off machinery, is to understate the position. But we did not have the cash flow to service big debts.

Then the seasons turned dry again. To service their debts the Eastern farmers found themselves doing many things that had been no part of their intention. They found that older and cheaper machinery would do the job. Many actually farmed more acres with machinery that was a fraction of the value of a few years before. Some took their children out of boarding school, and most ducked the annual holiday. Some sold out to more cautious neighbours or outsiders. Land values fell sharply.

With that vision that only comes with hindsight, it is easily seen that the investments for which the farmers had gone into debt were often, in commercial terms, of poor quality. Air conditioned cabs, the new shed and the swimming pool are all pleasant, but they do not generate enough income to pay the interest bill.

Even though text-book economics has little to say about it, we have all observed the tendency to incur debt when credit and profits are easy. Sometimes status and comfort are bought on tick. Debt may buy low-quality investments. When this happens and the good times move on, debt matters. Every reader will have his or her own story of a community whose members, when viewed with hindsight, can be said to have borrowed unwisely. I admit that not borrowing can also have attendant costs, but these costs tend to be less traumatic.

In the nation's case, the equivalent of the Eastern Wheatbelt's good seasons has been the confidence engendered by a high level of demand and economic growth of 4 to 5%. Individual people and firms alike have invested in everything from swimming pools to CBD office space and lathes. Australian demand has run ahead of Australian supply which has been supplemented from overseas. If the foreign debt has not financed high-quality investments which will pay the interest, or if we cannot confidently expect better times tomorrow, then the foreign debt will matter.

It seems to me that loose monetary policy gave Australians an unjustifiable sense of euphoria. I know that the measured monetary aggregates (M1, M3, M-whatever) alone are not perfect indicators of the tightness or looseness of monetary policy. Even so, when we see that M3 grew by a colossal 24.3% in the year to April 1989 we can, with confidence, say that monetary policy has been loose.

Because Australian goods and services have remained relatively costly, the excess money attracted imports. Part of the problem has been that since financial deregulation, near record interest rates have not reduced the monetary aggregates as much as expected. They have, instead, attracted foreign capital and kept our dollar high. A high dollar has made it even more difficult to earn foreign exchange. Reducing demand by raising the discount rate of government bills does seem to have acquired a certain catch 22 element. Even so, the other, and better, way to reduce demand, a much larger budget surplus, has been ruled out of contention by the government.

Nearly everyone agrees that the best and indeed only long-term solution to the current account problem is to deregulate the economy, including the labour market. Only then will investments be attracted to the most productive activities. Then it will be possible for Australian supply to expand to match a much more rapid increase in demand than is at present possible without the economy becoming overheated. Then we will be able to generate the foreign exchange to buy our imports and, if we don't have too much of it, service our debt. Even if there were the will to implement them, these,

so-called, micro-economic changes would, however, take time. In the meantime, increases in real demand will have to be kept down to around 2%, if we don't want to go on adding to debts which in hard times may become crippling.

Moreover, if we are unlucky with seasons or prices, much lower consumption (i.e. living standards) may be the only way left to generate the net exports (excess of exports over imports) needed to service the debt in the short run. (Remember, 20% of our export income is already required simply to pay for the interest on our foreign borrowings.)

What ever happens, the burden of debt, though incurred by those who borrowed in international money markets, will be shared around through lower wages and high(er) interest rates. If living standards are kept artificially high, or we should be unlucky with prices and seasons, then a spiral in which devaluation and inflation follow each other will ensue. Unemployment will then be inevitable. Social tension will increase. That is the Argentina road. Who wants to run the risk?

John Hyde is the Executive Director of the Australian Institute for Public Policy.

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