

The DEBT Controversy

We're in the midst of our most serious postwar trade crisis. Or are we? Economic goals have to be subordinated to halting the debt slide, before it's too late. Or do they? In recent weeks our economic crisis has been a subject of controversy. This ALR special feature assembles a formidable range of adversaries for the debate...



Our debt crisis has become the *bête noire* of Paul Keating's economic strategy. Employment and economic growth have taken the back seat. In the process economic policy has been reduced to a single hefty blunt instrument - high interest rates. Both the disease and its supposed cure have become the stuff of controversy. Is the high interest rate policy unavoidable? Or have we overreacted? What alternatives are there? And what can we do to reduce the social cost?

This ALR special feature brings together a spectrum of views. Patrick O'Leary, chief strategist for the

ANZ's stockbrokers, mounts a staunch defence of Keating's interest rate policy. Professor John Nevile of the University of NSW argues that wage earners can't ignore the debt. *Financial Review* economics editor Michael Stutchbury surveys the international situation and its lessons. SBS TV's business analyst Dick Gross looks at the social cost. Political economist Evan Jones argues for reconsidering foreign investment. And union economist Howard Guille suggests that the balance of payments is a fiction, and should be abolished. This is a definitive debate in Australia's most important controversy...



No Alternative

Patrick O'Leary is a partisan of Paul Keating's high interest rates policy. Here he talks to David Burchell.

Just how important is the balance of payments? In recent weeks a number of academic economists have been quoted as arguing that there's been much too great an emphasis on the problem. Some have argued that, in today's world economy, it's something of an anachronism. Others have argued that, ultimately, the private sector debt is its own problem, and that the government shouldn't be endangering the health of the broader economy with bailing out private sector debt. What do you think about these arguments?

I take the rather orthodox view that a nation, even with deregulation, can be compared to a household or an individual enterprise which only oversteps the mark at its peril. Over the long haul incomes and expenses have to reach an equilibrium. For an economy to persist in constant excesses of consumption and reinvestment over domestic savings, and therefore to run an increasingly large balance of payments deficit, is incipiently unbalancing to the long-term performance of the economy and ultimately to the living standards of the people who live within it.

I certainly disagree with the heterodox view that the balance of payments is an unimportant issue, and all that one needs to do is concentrate on domestic political settings. Ultimately it's the international foreign exchange community which pronounces on an economy's performance. And one of the most important ways it has of pronouncing on that performance is to view progress on the balance of payments.

An economy which does overstep the mark - which has national expenditures rising substantially above national incomes - will suffer a depreciation of the exchange rate. At some stage one gets to a point of no return, where subsequent devaluations of the currency only make the situation worse. And yet there is no way back for the exchange rate. We've seen what can happen in certain South American republics, and not all that long ago in certain Central European economies. The result is a crushing of living standards, and eventually a collapse of the political institutions. I would hope that Australia is adult enough to avoid that.

So the famous 'banana republic' phrase wasn't just rhetoric?

No. The timing of the banana republic statement was quite apposite. Remember, that took place in the middle of the biggest terms of trade collapse that this country has experienced in recent times. I think the sentiment underlying that statement still applies.

What about the longer term ability of the Australian economy to get out of this situation? It's difficult to imagine how growth in any particular export industry or potential export industry would, by itself, be able to get us out of this hole.

We would need a lot of luck and a lot of different commodity categories to pull us out purely by dint of exports. We would need a combination of import depression and export growth to make any real inroads. There are certain new export hopes - most significantly liquefied natural gas, which has begun to flow abroad. We are also seeing an improvement in coal export performance. There is potentially a lot more headway to be made with other mineral exports and we may do quite well on, say, grains and wool. But the real answer has to lie in the depression of import demand and that, unfortunately, relies on the depression of both consumer and investment demand here. That is what the current monetary settings are designed to achieve.



So you feel that Keating's policy is the only alternative?

It's the only relatively quick acting alternative. The long acting one, so far, has been rather difficult to achieve and it also involves major attitudinal changes - as well as probably increased levels of immigration of certain types of people who can add value, if you like, to what we produce and provide us with a much bigger domestic base from which to launch an export drive.

There's a lot of concern at present that the interest rate strategy could push us into a recession.

I think that's a very real worry. It is arguable, since Mr Keating was compelled to emphasise monetary policy at the

expense of the more classical mix of monetary, fiscal and wages policy, that monetary policy has been wielded too heavily and that the impact, particularly on small and medium-sized business, may be much more deleterious than was calculated. It seems at the moment that the banks, having suffered from certain well-publicised major corporate failures, are pretty reluctant to go on extending credit facilities to long-standing customers who are not all that big. In consequence, the cash-flow requirements of Australian business are increasingly being met by pressuring debtors. In other words, one is seeing a collapse in the velocity of circulation of cash in the business sector. That exacerbates the downturn in growth, and it will certainly squeeze the labour market, which is regrettable. I don't think much of this was foreseen in the application of Mr Keating's rather harsh monetary policy, but I think the effects will be seen quite soon.

Some academic economists have been arguing recently that the cure is worse than the disease: that it's counter-productive to dampen down the economy at a time when you're trying to promote exports. What do you say to that?

You can probably take that one too far. The idea is to dampen down domestic demand relative to foreign demand. That's the only way you can increase the volume of exports. If at the same time you can depress the exchange rate and give your manufacturing sector a competitive advantage, so much the better. The problem has been that monetary harshness has tended, until quite recently, to push the exchange rate the wrong way. We suddenly depressed domestic demand, but we also pushed the exchange rate up to the point where we couldn't penetrate foreign markets. That, I suspect, has now been reversed. The markets have seen through the attractions of high Aussie interest rates and have essentially abandoned the exchange rate, so the desired effect of high interest rates on levels of domestic demand are now coming through.

So, will there be a recession next year? Or are we headed for a 'soft landing'?

I don't think we're in for a recession in the conventional sense. The classic definition of a recession is a succession of negative quarterly GDP results. I would characterise what we are about to have as a domestic demand recession of some severity in which aggregate spending or domestic demand will be falling at an unprecedented rate. That will mean a huge decline in growth - although I don't think it will fall below zero. However, the effects may well be similar to the effects of a full-blown recession. We are bound to have labour market effects which won't be pleasant. The unemployment rate is going to rise and we're also going to have distress in the corporate sector - the two go together. I'm reasonably satisfied that the effects won't be all that long-lasting. However, because of the debt problem, I don't think we are going to be emerging from this like a lion.

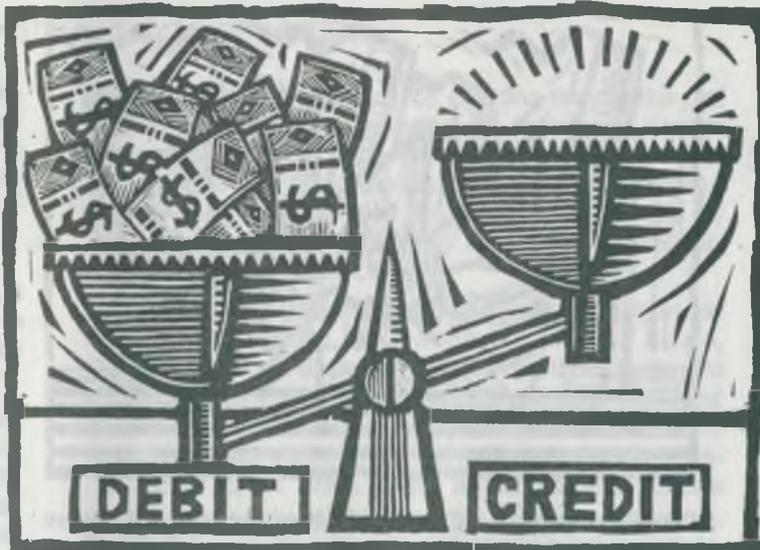
There is, of course, another consideration from Paul Keating's point of view.

Yes, a major one.

What do you think of the chances of the government riding through this highly unpopular electoral period, not to mention convincing the electorate that it's necessary?

I think reasonably good at the moment. I would probably have given you a different answer a few weeks ago. The

government now is more concerned about the track of unemployment than about the level of interest rates. What would be lethal is a combination of high and immovable interest rates and rising unemployment. On the whole, the government has managed to deflect the blame for interest rates onto the banks. That's been a reasonably well-run campaign. The banks have fought back, but I think unsuccessfully so far. It is unlikely that the government can deflect the blame for rising unemployment onto anybody else, so that's the danger. There certainly has been a loss of core support for Labor, but



I doubt whether the disappointment will be sufficient to return a conservative government.

There aren't many concrete alternatives being put forward by the Opposition at present, are there?

No. It's a bit of a Mexican stand-off. The opposition is reluctant to put any concrete alternatives before the people until it knows what the government has in mind. The government is just as frustrated because it can't get its hands on anything the opposition might think. So there is nothing of substance in the intellectual debate at the moment. People are therefore quite confused; they know that they're hurting, they know that they're disappointed, but they know that the Opposition hasn't come up with anything too concrete or too credible so far.

At the same time, of course, there's been disquiet in the government's own ranks in recent weeks about the interest rates policy. There was a meeting of backbench dissenters a few weeks ago. It was pretty effectively muzzled by the government. Yet one suspects that a considerable number of Labor MPs privately agree with the sentiments expressed there. And out of that dissatisfaction, both inside and outside the government, a number of alternative policy prescriptions to the Keating strategy seem to have emerged. One that comes to mind is the reregulation of the financial markets. That's a proposal which is often used as a kind of clincher, as it were, in the arguments against Keating's policy from the left. What's your opinion?

I think it's an impossibility. That may be unfortunate, but it's true. You simply cannot shut Pandora's Box. You have to live with the miasma that comes out of it. Over the long

haul it is probably a constructive thing to have financial market deregulation, provided the consequences are reasonably well managed. You could argue perhaps that they have not been as well managed as they might have been.

Pandora's Box?

Well, you don't just deregulate certain parts of the financial market. The whole thing has to occur as a logical sequence of events, and we've proceeded through them very fast. We can't for example, repeg the exchange rate, we can't dictate the level of interest rates, we can't legislate for a maximum



overdraft rate and still have a floating currency. If we were the first nation to repeg our currency to some sort of dictated yardstick we'd be very heavily sold off. That would put immense pressures on the central banks to hold the line. We'd probably run out of reserves in ten minutes. The biggest benefit and the biggest political millstone with financial market deregulation has always been that, once you do it, you abandon sovereignty over domestic political settings. You cannot run the economy the way that you would like to politically because you open yourself to the instantaneous judgment of foreign markets. I personally don't think this is a bad thing; it makes individual political lunacy so much more difficult to achieve.

But if you're trying to ameliorate the effects of certain trends in the world economy, it makes it very difficult to kick against the pricks, doesn't it?

It does, but you then have to go for some co-operative effort - perhaps to peg currencies against some chosen basket, or some commodity or other. There has obviously been some progress in that direction in Europe. There's constant talk about the establishment of some new world currency; perhaps by bringing gold into it. We just can't do it by ourselves.

The other chief plank of a leftish alternative to Keating's policy within the ALP and probably elsewhere on the left, is import substitution. Among left academic economists, it's certainly the most popular prescription at present. What do you think of it?

Well you can come at that two ways. You can either boost the supply side of the economy and make certain that the quality of the goods and services which are supposed to substitute for imports enjoins the support of the consumer here, or you can legislate against imports in one way or another. The latter is most imprudent for a nation which is part of a community of trading nations, simply because we

would be retaliated against if we legislated against imports. The former is emphatically the best way out. However, insufficient progress has been made in the supply side of this economy, particularly on quality, to get people to buy Holden or locally-made Ford motor cars in preference to Honda and Toyota. The intermediate position, which was tried by Mr. Hawke himself a couple of years ago, is to run a campaign to buy Australian.

It wasn't very successful...

Most people would buy Australian if the quality were comparable, never mind the price. If we can't produce the goods, then the moral suasion part isn't going to work very well.

Laurie Carmichael, for instance, talks about the need for just one world-class competitive industry. How likely do you think it is that we'll develop such industries in Australia over the next few years?

Well, the wool industry is competitive on a world scale. It is extremely well-run by world standards. There's a good marketing drive, and the perception abroad is that Australian wool is tops. It's a bit harder to imagine doing that with coal or alumina or bauxite. I can't think of too many examples of Australian manufactured goods which enjoy a world-wide reputation for quality and reliability. In industries like machine tools, for example, we're nowhere; in applied technology we're not terribly advanced. In motor cars, who knows, Ford may succeed with its soft top exports, but there aren't too many success stories.

Meanwhile other countries, with historically stronger manufacturing sectors than our own, have been undergoing a worrying process of contraction in manufacturing in recent years. What are the prospects of our manufacturing industry bucking that trend?



Relatively poor, I think, until we manage to clean up our micro-economic reform act. Progress has been made in labour relations, but micro-reform has stalled, and that's a long-term problem. We may be able to compete in price, as the exchange rate continues to move down, but price alone isn't sufficient. I'm a bit pessimistic, frankly, about the long-term prospects for manufacturing. I shouldn't be, because we have most of what it takes to be viable. But we don't have the application, we have not yet been able employ the marketing skills, and we haven't got a good record for deliverability.

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