

International capital rules OK?



Michael Stutchbury outlines the international debate.

Compared with the stagflation of the 1970s, the Australian economy in the 1980s has been marked by effervescent expansion. Consumers, housebuilders and business are spending 39 percent more (after adjusting for inflation) than they did during the pit of the 1983 recession.

This should be good news - and, in some important areas, it is. The job boom has cut unemployment from 16 percent to 6 percent as well as absorbing an accelerated surge of women into the labour force.

The bad news is that Australia's work stations have not been able to supply much of this increased domestic demand. While demand has grown by 39 percent in the past six years, national output has increased by only 34 percent. This excess of demand over supply has overflowed into imports and produced the well-documented blow-outs on the balance of payments and the country's foreign debt. It is difficult to see how Australia can avoid running a foreign debt of at least 30 percent of national income for most of the 1990s, leaving it continually vulnerable to adverse developments in the world economy.

The so-called 'strength' of the economy has been concentrated on the demand side. Keating's problem is that his increasing reliance on high interest rates to hose down this demand has the perverse effect of discouraging business investment in the new productive capacity. That is discouraging the future domestic supply of goods and services.

The story of how the world's greatest Treasurer got cornered into this policy jam is largely the story of why spending has been so stubbornly strong in the first place.

Big lessons have been learned here. In contrast to the ACTU's 'under-consumptionist' arguments of the 1970s, Labor's ability to get trade union compliance with real wage cuts has not depressed spending. Instead, as more women have entered the workforce, it has kept household income and spending bubbling along. Nor has Labor's startling fiscal turnaround from an \$8 billion budget deficit to a \$9 billion surplus put a clamp on aggregate demand in the economy. Lower wage costs and a higher profit share has helped here.

But an even more problematic source of the Australian spending boom of the 1980s has been the foreign factor. For foreigners, read Japan and West Germany - the high income economic superpowers whose rapidly ageing populations have accumulated huge savings for their retirement. In the 1980s, the international liberalisation of capital controls has let these savings loose in a worldwide search for the highest rate of return. This international portfolio transfer is trans-

forming the world economy: by directing the remaking of Western Europe, by encouraging the thawing of Eastern Europe and by lubricating the rising economic power of Asia-Pacific. It is no coincidence that, despite the regular predictions of apocalyptic financial collapse, the industrialised world is about to enter its ninth year of uninterrupted buoyant expansion.

As well, this capital outflow from Germany and Japan has been siphoned into the Anglo-Saxon economies of Britain, the United States, Canada and Australia, partly reflecting the attraction of high nominal interest rates and partly reflecting investment opportunities in the 'productive' sector. These capital receiving countries also have liberalised their financial sectors in the 1980s, giving households and business more freedom than before to go into debt. In other words, financial deregulation has allowed people more latitude to borrow now in order to spend now more than they produce. And, with an eye to their retirement years, the Germans and the Japanese have been willing to lend.

Likewise, as a result of international financial deregulation in the 1980s, individual countries have greater freedom to lend to and borrow from others with the removal of capital controls. This shift goes to the core of the new Australian debate - fuelled by Australian National University economist, Professor John Pitchford - that balance of payments deficits and rising foreign indebtedness are not necessarily a 'problem' that needs correction by economic policy makers. Particularly since the Australian government has pushed its own budget into surplus, why should it care whether individuals or large corporations want to borrow from abroad?

This same debate has bubbled up in most of the capital receiving countries in the 1980s. In the US Treasury, for instance, it is argued that the continued large American trade deficit and the country's sharply rising foreign indebtedness do not represent national weakness but the strength of an economy which can attract \$US135 billion a year in foreign investment to finance its trade deficit.

Unfortunately, the issue is not as cut and dried as this. We know that globalised capital markets can finance larger trade deficits or surpluses for longer periods than in most of the regulated post-war period. But we also have evidence that capital markets are also prone to 'speculative bubbles' - like the 1986 and 1987 world stock market boom - that end up being pricked with a loud bang. Thus, we cannot completely dismiss the doomsayers.

The old economic theories held that a country running a large trade deficit would find its currency depreciating, which would make its exports cheaper on world markets and make

imports more expensive on its home markets. But now, capital movements in search of investment opportunities seem to play just as great a role in determining exchange rates. And, from the International Monetary Fund in Washington to the Organisation for Economic Co-operation and Development in Paris, international economic policy advisers find themselves without any strong theoretical grounds for predicting whether a given trade surplus or deficit is 'sustainable'.

The bottom line, I believe, will depend on to what use the capital importing countries put this foreign money. If - as appears to be the case in the US - much of the capital inflow is being used to finance a high standard of living that Americans have become accustomed to, the result could end up being economic impoverishment. Such countries would not have developed the extra productive capacity to pay back their creditors. But if - as is the case in Spain, for instance - the capital inflow is going into new factories, the result will be enriching down the track.

For Australia, the picture is mixed. Much of our capital inflow is going into financial assets yielding very high interest rates. Some is going into tourism resorts, office development, cattle stations and mining. Relatively little, outside the foreign-owned auto oligopoly, is going into manufacturing.

Among overseas industrialised countries, as well as in Australia, the big new theme for economic policy is so-called structural adjustment (what we call micro-economic reform). In Australia, the debate is increasingly focussing on whether the tax system, in combination with inflation, biases capital spending toward so-called non-productive investment such as central business district office blocks and housing. The policy implications here include reducing the business tax deduction for interest costs and extending the capital gains tax to the family home, and to doing more to smother inflation.

But it also increases the over-all urgency for micro-economic reform to overhaul the nuts and bolts of the economy. This obviously includes transport reform (such as the waterfront, coastal shipping, aviation, railways and trucking). It will extend further into the states' jurisdiction, such



as public transport systems and electricity generation. Generally, this micro push will concentrate on 'levelling the playing field' to allow market forces to attract capital to their most 'productive' use. But it could include 'interventionist' policy, such as a training levy on industry to correct the market 'failure' of business under-investment in skills formation.

Australia has always depended on foreign capital to finance its economic development. Yet our history has included periods - such as the 1880s and the 1920s - when the capital inflow was squandered. On both these occasions the accompanying foreign debt build-up led to long and painful economic corrections, the recession of the 1890s and the Depression of the 1930s. The coming decade should tell us whether we have learnt from these lessons of our past.

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Why the deficit matters

John Nevile argues that wage-earners can't escape it.

Australians are being asked to 'tighten their belts' and accept painful economic policy measures, including extremely high interest rates and very tight fiscal policy, in order to reduce the current account deficit on the balance of payments. The majority of

Australians, including most wage earners, have no option but to accept the effects of these policies since the working of the labour market, heavily influenced by the arbitration and conciliation system and the Accord, prevents them from just increasing their own incomes enough to