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.

MICHAEL STUTCHBURY is economics editor for *The Australian Financial Review*.

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

offset the effects of high interest rates and tight fiscal policy.

Now it is reported that many economists, led by Professor John Pitchford of the Australian National University, are arguing that the current account deficit and the consequent trend in the foreign debt are of no importance. Is the tough economic policy imposed on Australia unnecessary after all?

Roughly two-thirds of Australia's foreign debt is owed by the private sector and a large part of the rest is debt of public trading enterprises such as electricity commissions. At first sight this foreign debt is just a manifestation of the market system. If firms borrow abroad it is because they expect it to be profitable to do so and, if they are correct, the projects financed by the foreign borrowing will generate income to serve the debt. Of course, firms may make mistakes and go bankrupt but, while this is a problem for their employees and shareholders, it is not for other Australians. If a state electricity commission makes a mistake there is a cost to taxpayers in that state, but the cost is there whether or not the mistake was financed domestically or by borrowing abroad. Why should we worry about borrowing outcomes produced by market processes?

The classic answer is that these decisions may have costs outside the firm making the decision, and these external costs will be ignored in the decision making process.

Unfortunately the decisions to borrow abroad do have external consequences, particularly for the exchange rate. In the short run, in an environment of high interest rates, they tend to prop up the exchange rate, leading to an overvaluation of the Australian dollar. But the larger the foreign debt (or, more accurately, the greater the cost of servicing the foreign debt compared to the value of exports) the more likely it is that foreigners will come to the conclusion that the situation is becoming unviable and that soon there will be a large devaluation of the Australian dollar. Once enough foreign lenders take this view, a large devaluation is inevitable. It is only if one is not concerned about such a devaluation that one can be unconcerned about the trend in the foreign debt.

It is significant that Professor Pitchford characterises those concerned with the size of the foreign debt as using an analysis developed from countries with fixed exchange rates, which he argues is now irrelevant in an era of floating rates. However, the fact of floating exchange rates does not remove the consequences of a large devaluation. Assuming that the devaluation is sustained and not quickly reversed, it will raise the prices in Australia of imported goods and of some goods that Australia exports. If wages rise to compensate workers for this rise in the cost of living, the devaluation will have changed little. Soon the foreign lenders' worries will surface again, leading to a further devaluation, and more price and wage rises with a disastrous inflation-devaluation spiral developing.

If wages do not rise to compensate workers for the devaluation induced-rise in the cost of living Australia will not suffer the dire consequences of a devaluation-inflation spiral, but there will be a fall in real wages and a shift in income from wage earners to exporters and to the profits of firms producing goods that compete with imports. A large devaluation will cause a large shift in income and if large current account deficits continue indefinitely we will have a very large devaluation.

What then can be done about it? High interest rates are a temporary solution reducing the demand for imports and encouraging foreigners to lend to Australians. Now that the boom in the Australian economy has peaked, interest rates can be reduced slightly, which will probably lead to a small devaluation, which in turn will help improve the balance of payments situation without causing a large shift in income distribution.

While any reduction in interest rates must be cautious, it is important that they be reduced in the longer run, not only because of the consequences of high interest rates for home buyers, but also because they discourage business investment which is an important part of any long run solution.

The Opposition's policy (at least judging from its television advertisements) is to lower interest rates and simultaneously make fiscal policy much tighter through larger cuts in government expenditure than any contemplated by the government. This may be fine, if one is rich enough not to be concerned with the state of health of public hospitals or schools, and with no thought of ever needing to rely on an old age or invalid pension, an unemployment benefit or a family income supplement. In any case, fiscal policy in Australia is now extremely tight compared both to historical Australian experience and to that in other developed countries.

The only satisfactory solution in the longer run is to increase productivity so that the Australian economy can become more competitive internationally without a reduction in real wage rates. A continued high level of business investment is important in this, but so is award restructuring and all the multitude of factors brought together under the phrase of micro-economic reform. Any solution other than increasing productivity growth will involve a declining standard of living for most wage earners.

JOHN NEVILE heads the Centre for Applied Economic Research, University of NSW.