Will We Survive the Debt Crisis?

Tom Valentine

ISSN: 1036-7373
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The size of the external debt inherited from the nineteen eighties has generated a great deal of concern and debate. Many commentators, particularly those from the private sector, were concerned about the implications of this development. Others, basing their analyses on the arguments of Pitchford (see, for example, Pitchford (1990)), suggested that the accumulation of debt has no great significance.

The present paper surveys the arguments advanced in this debate. The thrust is in line with the first view, but it is not inconsistent with most of Pitchford's position. In fact a careful reading of Pitchford suggests that his major concern is with the adoption of the current account deficit as a target for monetary policy. He also argues that if overseas funds dry up, the resulting fall in the value of the AUD would produce the necessary adjustments in the economy. Nevertheless, he favours microeconomic reforms which might have the effect of reducing the current account deficit.

The Magnitude of the Problem

As at June 1992 gross foreign investment in Australia was $301bn and gross Australian investment abroad was $102bn, giving net foreign liabilities of $199bn. 64.2% of gross foreign investment in Australia was in the form of borrowing and other short-term claims and the remainder was equities. In the case of gross Australian investment abroad, 43.1% was in the form of borrowing and other short-term claims. The net figure is often quoted as an indicator of Australia's external debt problem, but given that our liabilities appear to be shorter term than our assets, gross foreign investment may be a better measure of the magnitude of the adjustment problem. In the event of a crisis, only the reserves of the Reserve Bank will be available for rapid deployment to offset the pressure. It will be argued below that such resistance would not be desirable. Private

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1 This paper is a revised version of one presented to Centre for Independent Studies, Autumn Public Policy Forum "Should We Worry About The Foreign Debt?", 11 May 1993 in Sydney.
holders of offshore assets are unlikely to part with them in an environment of a falling AUD\textsuperscript{2}.

Some 85\% of foreign investment in Australia was provided to the non-official sector which includes public enterprises such as Qantas. This factor has been regarded as significant by some analysts, a point which will be considered below.

**A Moral Dimension?**

Benjamin Friedman (1989) argues that the accumulation of external debt raises a moral problem as well as an economic one. It has always been part of the value system of Western nations that we should leave the next generation with greater wealth and productive capacity than that which we inherited. Since a current account deficit means that current expenditure exceeds current production, this generation may be leaving our children in a position which is less favourable than the one we inherited.

This question is not, however, unrelated to economics. As a number of commentators have pointed out, the accumulation of debt will not be to the disadvantage of later generations if it was used to finance productive investment, particularly investment in export and import competing industries. Friedman goes to a lot of trouble to establish that the productivity and competitiveness of the US economy has not been increased by this process. In the Australian case investment was stagnant in most of the years in which the external debt was accumulated and a considerable proportion of savings went into dwelling investment. It is probably better to view Australia's external debt as a reflection of high government borrowing (more for consumption purposes than public capital formation) and low domestic saving than as a source of finance for productive investment.

\textsuperscript{2} The effects of Reserve Bank intervention are discussed in the Appendix to this paper.
Nevertheless, there is a non-economic flavour in this argument. As suggested by Pitchford, individual economic units made the decisions which resulted in the external debt. That is, it is a market outcome. If we question this outcome, we are attempting to second-guess the market and falling victim to what is usually an illusion - the belief that intervention will produce a better outcome. While there is some validity in this criticism, concern about the level of external debt is not equivalent to the identification of a market failure. To a large extent, the accumulation of external debt can be attributed to government intervention in the economy, most directly by its demands on the funds market but also through the distortions created by the taxation system, government intervention in industry, etc. "Intervention" in this case involves the removal of government induced distortions in the economic system and Pitchford explicitly endorses initiatives of this kind.

The Dangers of External Debt

An important problem with the accumulation of external debt is that it becomes increasingly difficult to reverse the process. At the moment Australia has a balanced trade account, but debt continues to accumulate in order to cover the interest payments on the existing debt. This process would accelerate if interest rates rose again.

As the debt accumulates, the country's credit rating will be downgraded which will increase the cost of the debt. Also, as overseas investors become concerned about Australia's capacity to meet its obligations, they will demand that a higher risk premium be included in the return on their investments. Max Walsh (Sydney Morning Herald, March 24, 1993) has noted that while Australian and US real bond rates were quite close over the period 1978 to 1989, there is now a premium of up to 6% on Australian paper. This increase in the risk premium will in turn force Australia to maintain high interest rates. Uncertainty about the reactions of offshore lenders and the magnitude of the risk premium which they will demand is also a source of volatility in foreign exchange markets.
Also, the borrowing can only be sustained by selling assets to non-residents. This puts upward pressure on domestic asset prices and it increases the level of foreign ownership in the Australian economy. In reference to the second point, the media often expresses concern when well known Australian companies look likely to fall under foreign ownership. This concern fails to take account of the fact that offshore borrowing of $15-20bn per year requires us to provide foreigners with ownership of that amount of Australian assets. If it is not one company, it is likely to be another.

The scenario of most concern is that a point will eventually be reached when funds are not available at any cost i.e. overseas markets stop lending to Australia. This "worst case scenario" cannot be regarded as highly unlikely. It is precisely what happened in 1929. Such a development would require immediate adjustments which create a surplus in the balance of trade sufficient to cover service payments on existing debt. This would require a severe deflation to reduce imports and to free up products for export.

Some Arguments on External Debt

At this point it is convenient to consider some subsidiary arguments which have been advanced in the external debt debate.

(a) The major part of external debt is private which indicates that

- its accumulation was the result of private decisions not government action; and
- this will ease the adjustment process.

These arguments are incorrect. First, while it is true that in contrast to the nineteen twenties, most offshore borrowing in the eighties was non-official, this does not mean that the Government is free of responsibility for the external debt. Government demands on domestic markets in the eighties forced private borrowers to access international markets. This view provided the rationale for the Labor Government's push to create a budget surplus.
Secondly, whether the debt is public or private makes little difference to the magnitude of the adjustment in the economy that will be necessary if offshore funds dry up. Whatever the composition of the debt, the same surplus will need to be created in the balance of trade.

One argument that is sometimes advanced is that part of the debt will be cancelled because of the bankruptcy of some private borrowers. This is a strange argument. A default by some private borrowers is just the type of event which would precipitate the crisis envisioned in the worst case scenario described above. In addition, defaults are likely to lead to an increase in the risk premium demanded by overseas investors.

(b) A significant part of the external debt is denominated in Australian dollars and this reduces the seriousness of the problem.

The denomination of part of the debt in Australian dollars reduces the extent to which a depreciation of the AUD will increase the AUD value of the debt and debt service payments. It does not, however, reduce the surplus which will have to be created in a "worst case" situation.

(c) Although Australia has increased its external debt, net worth has also increased so that we are better off.

In interpreting this argument it must be remembered that a large part of the asset accumulation is in the form of housing which does not produce exports or import competing products. As Friedman (1989) has argued, the important thing is the amount of productive capital per worker and Australia's performance has been relatively poor in this area.

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3 Arndt (1988) notes that external imbalance should be defined in terms of foreign currency not domestic currency. The increase in the AUD value of the debt service payments does not increase the rate of accumulation of debt.
This argument can also be looked at from the viewpoint of lending to domestic borrowers. One of the lessons of the eighties is that it is not a borrower's assets which prevent a default - it is his cash flow. In the case of a country the "cash flow" needs can be defined in terms of the foreign currency needed to bridge the gap between imports plus service payments on existing debt and exports. If the capital inflow ceases, the gap cannot be covered by selling assets because (as with individual borrowers) there will be no market for them at such a time. As already argued, it appears that the only way the required cash flow can be generated is to deflate the economy so that imports are reduced to the required level.

Is Saving Deficient?

The external debt problem is at times attributed to excessive government borrowing or to deficient saving. The second explanation receives some support from the dissection of Australia's saving performance by White (1993), but it is often questioned on the basis of comparisons with other countries. Closer examination of these comparisons suggests that the savings ratio is higher in economies which have performed well. Nevertheless, this comparison is largely irrelevant. Australian saving is deficient relative to the demands put on it by business and government borrowers and the shortfall creates a need for heavy foreign borrowing. The problem can be solved by a reduction in the domestic demand for funds or an increase in domestic saving or both. A reduction in the demand for funds can be created by a fall in investment or a reduction in government budget deficits, with the latter likely to have the least harmful long-term effects.

Gregory (1991) introduces another criticism of the standard view of saving by questioning whether the low savings ratio can be regarded as causing the current account deficit. He suggests that the causation is actually reversed i.e. the savings ratio is determined by the current account deficit, possibly with a lag. He also provides some empirical support for this view in the form of an equation relating the savings ratio to past and present values of the terms of trade.
This question of causation is actually an empty one. All of the variables entering the "twin deficits relationship" are determined by the economic system (in the terminology of economists, they are endogenous). This is clearly the case with savings, investment and the current account deficit, but it also appears to be true of government budget deficits. All of these variables depend on the variables which feed into the system but which are not determined by it - exogenous variables in the economist's terminology. The list of such variables would probably include the cash interest rate, the structure and level of taxation, social security arrangements, wage levels, the terms of trade, etc. The variables entering the twin deficits relationship can be altered by changing these exogenous variables, but the precise changes which would result are difficult to predict without a complete knowledge of the structure of the economic system. Nevertheless, it should be possible to devise policies which will change the endogenous variables, including the current account deficit, in the desired direction. For example, policies which increased the saving ratio seem likely to lead to an improvement in the current account deficit.

On the other hand, it now seems to be agreed that increasing interest rates is not an effective way to reduce the current account deficit. A simple elaboration of the effects of a tight monetary (high interest rate) policy:

- a higher interest rate will lead to a reduction in consumption and investment expenditure, reducing imports and therefore causing a reduction in the current account deficit;

- the higher interest rate will cause an appreciation of the AUD which could have the following effects:

  - an increase in the current account deficit, corresponding to the higher capital inflow induced by higher interest rates;

  - an indirect addition to the restrictive effect of high interest rates on aggregate expenditure.
The experience of the late eighties suggest that there is a considerable lag in the effect of higher interest rates on aggregate expenditure. The impact on the exchange rate is immediate so that the initial effect of a monetary tightening is likely to be a worsening of the current account deficit. Also, the appreciation of the exchange rate will reduce inflation. A tight monetary policy is therefore likely to be more effective in reducing inflation than in controlling current account deficits.

The Adjustment Process

The adjustment which could be made necessary by the emergence of the "worst case" scenario will be facilitated by a depreciation of the AUD. The AUD can be protected for a short time by running down the Reserve Bank's foreign currency holdings, but prolonged resistance of this type cannot be long lived. In addition, it will simply postpone an inevitable readjustment and it is likely to make market sentiment even less favourable to Australia. The depreciation of the AUD would not remove the need for an initial deflation of the economy, but it would promote the restructuring necessary to maintain an economy cut off from offshore finance i.e. the expansion of export and import replacement industries. The contribution which a flexible exchange rate can make to this adjustment process is a major argument in favour of the floating exchange rate regime.

As the experience of the nineteen thirties shows, the adjustment process is likely to be drawn out and generate serious long-term social problems. It is true that the exchange rate was not flexible in the thirties although it was devalued when it came under pressure. On the other hand, nominal wages were more flexible in the thirties - a 10% cut occurred in 1931 - although flexible prices meant that there was no cut in real wages. Real wages increased in the twenties and it proved impossible to reduce them in the thirties. Our current situation is similar in that the sharp increase in real wages in the

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4 Recent experience suggests that this effect is not symmetric in that an easing of monetary policy has not reduced the current account deficit. It should be remembered, however, that this easing was combined with a substantial increase in official borrowing.
seventies has never been reversed. Nevertheless, falling nominal wages and prices did lead to a fall in the real exchange rate in the thirties. A nominal wage cut is not possible in today's industrial environment. Moreover, it is quite possible that unions will demand a nominal wage increase to offset the inflation caused by the depreciation of the AUD which would minimise the contribution of such a fall to the adjustment process.

Possible Policy Responses

Given the high costs likely to be attached to any adjustment process, it is worthwhile considering policies which would either reduce the chance of a crisis emerging or reduce the costs of the adjustment arising out of such a development. The most pressing need in this area is to reduce the Commonwealth budget deficit. The agenda covered by the term "microeconomic reform" is also relevant in this context. There follows some examples of such policies although the list is by no means exhaustive.

First, any policies which increase domestic saving will reduce Australia's dependence on offshore funds. The policy most likely to be introduced is an expansion of the superannuation charge, including its extension to employees. An alternative worth consideration is the easing or removal of the taxation of interest receipts. Apart from the impact on saving, the taxation treatment of interest payments is inequitable in that it taxes compensation for the effects of inflation as though it is real income and encourages speculation through the negative gearing of asset purchases. Saving would also be fostered by a shift in the taxation system away from income taxes and towards expenditure based taxes.

The authorities face a basic dilemma in formulating policies to encourage personal saving. High income earners are likely to be the major source of such saving and will therefore receive the major share of any incentives offered. That is, any policies to increase saving are likely to be regressive with respect to income distribution. This was one criticism mounted against the GST, but it is hard to see any policy being successful in encouraging saving unless it has this characteristic.
Australia has relied on giving tax advantages to superannuation as a way of promoting saving. Superannuation is an attractive way of increasing saving because it also appears to represent a solution to the long-term problem of providing retirement incomes. This approach is also regressive and as Australia’s saving rate remains relatively low, it does not appear to have been particularly successful. The changes to be introduced as at July 1 1993 will make the advantage given to superannuation contributions less regressive, but may cause a further reduction in saving.

The approach emerging at the moment is to make superannuation compulsory and universal in the form of a levy. While it seems inevitable that this is the way we will go, there are some problems with this approach. First, the levy currently takes the form of a charge imposed on employers. For them it is simply an increase in wage costs which will have immediate employment effects. Since most higher income earners are already covered by superannuation, the employment effects are likely to be concentrated amongst those on low wages. Secondly, accumulation of savings in the form of superannuation could lead to a reduction in savings in other forms. This is particularly likely in the case of lower income workers. Thirdly, there is already a push to release some of the accumulating funds for housing investment. As will be discussed below, this is not a desirable redirection of funds.

One problem with the reliance on superannuation to provide savings is that it could lead to a bias in the direction of funds (a typical "unintended consequence" of government intervention). Superannuation funds tend to invest in the listed shares of large companies and very large projects, but not in corporate debt or debt or equity for small businesses. If it is thought necessary to provide incentives for saving for retirement, they should have more neutral effects. For example, tax benefits could be given to any savings vehicle approved for the purpose of the accumulation of funds to provide for retirement.

One policy to encourage business saving which has been suggested recently is to reverse the earlier move to the integration of the corporate and personal taxation systems. It is suggested that the imputation system of taxation creates a "bias" against the retention of
earnings (i.e. business saving). In fact, the introduction of this system of taxation actually removed a bias in favour of the retention of earnings. This bias meant that savings were not necessarily invested by those with the most productive projects available. When profits are paid out, they can be reinvested in the funds market and attracted by investors with access to the highest yielding projects. In addition, the Financial Accounts for the September quarter 1992 put out by the Australian Bureau of Statistics indicate that the dissaving of trading enterprises was considerably lower in 1991/92 than in 1990/91.

Finally, an argument against the provision of incentives for saving should be considered—that it represents the creation of a bias in the economy. In fact, a number of the policies discussed in this section represent the removal of existing biases against saving. In other cases, there is an attempt to offset existing biases. The second approach is less acceptable because the overall result is rarely neutral. Also, it can be argued that there is a justification for incentives for saving in that it provides benefits to other people in the economy (see Friedman (1990)) which cannot be charged for.

Reforms Which Do Not Increase Saving

Policies to increase saving must not be seen as a way to finance the Commonwealth budget deficit. That problem must be solved separately so that the higher saving can be directed into investment. A long-run solution to the problems described in this paper can only be achieved by an increase in productivity and competitiveness i.e. from policies to increase investment and the flexibility of the economy.

Policies that do not increase saving may not have an immediately favourable effect on the current account deficit (i.e. the rate of external borrowing). Nevertheless, they can have a beneficial impact in terms of

- increasing the real exchange rate and domestic living standards which could in turn lead to a higher saving ratio; and
• increasing the flexibility of the economy so that the costs of any adjustment which becomes necessary are reduced.

Policies which make wages more responsive to economic conditions certainly fall into the second category. Japan has achieved this flexibility through its bonus system and Singapore achieves the same result by reducing employers' compulsory superannuation contributions in economic downturns. These countries seem better able to absorb external shocks than Australia.

Expansion of the superannuation levy might eventually give Australia the same flexibility as Singapore. This is, however, a very long-term prospect. In the immediate future labour market reform is necessary in order to create the required sensitivity to economic conditions. This will require Australians to abandon the flawed legacy of Mr Justice Higgins. It made a major contribution to the unemployment of the thirties and it is contributing to current unemployment. Surely this is enough.

Another important area in need of reform is the taxation system which is at the bottom of many distortions in the Australian economy. It is unfortunate that reform has so far taken the form of marginal adjustments which often create new distortions and certainly add to compliance costs. It is time that the thorough approach adopted for financial deregulation is applied to the taxation system.

An important aspect of the taxation system is the encouragement given to housing investment. Pender and Ross (1993) show that unleveraged owner-occupied housing is subject to the lowest real effective tax rate of all investments, largely because of its exemption from capital gains tax and the failure to tax imputed rental income. They also note that most homeowners have a very low level of gearing. One way of looking at the taxation situation is to say that saving in the form of bank deposits is subject to "double taxation" (i.e. saving is out of after-tax income and the income on saving is also taxed) while saving in the form of housing is not.
Housing is also favoured in other ways. For example, it is exempted from asset tests for various forms of social security. Also, the BIS capital adequacy controls imposed on the banks give housing mortgages a 50% risk weight compared with the 100% weight applied to business loans. This incentive to lend on housing is particularly important at a time when the banks are under capital pressure arising out of their loan losses.

Housing does not increase the competitiveness of Australian industry and it does not produce exports or replace imports. Apart from political pressures there is little justification for the strong bias towards it in the Australian financial and taxation systems.

Conclusion

The answer to the question in the title of this paper is that we will certainly survive the debt crisis, but we may go through considerable pain as a result of it. Continuing accumulation of debt will lead to increasing interest costs, volatile exchange rates and could produce a crisis in which overseas funds dry up and a sharp adjustment is forced on the Australian economy. This adjustment will be facilitated by movements in the exchange rate, but it will nevertheless be a painful process.

The costs of this adjustment will be reduced and perhaps even the need for it removed by microeconomic reforms which increase domestic saving, the competitiveness of Australian industry and the flexibility of the economy. These reforms must include a significant reduction in government budget deficits, a thorough revision of the taxation system and steps to make wages more responsive to economic conditions.
References


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Appendix: The Effect on External Debt of Reserve Bank Intervention in the Foreign Exchange Market

Capital inflow is equal to the current account deficit minus the amount of foreign currency contributed to the market by the Reserve Bank. That is:

\[ \text{CIF} = \text{CAD} + \Delta FX \]

where \( \text{CIF} = \) net capital inflow
\( \text{CAD} = \) current account deficit
\( \Delta FX = \) increase in the Reserve Bank’s holdings of foreign currency reserves (corrected for valuation changes)

The twin deficits relationship is

\[ \text{CAD} = I + \text{PSBR} - S \]

where \( I = \) private investment
\( \text{PSBR} = \) Public Sector Borrowing Requirement
\( S = \) private saving

This means that

\[ \text{CIF} = I + \text{PSBR} - S + \Delta FX \]

This relationship shows that the Reserve Bank can reduce capital inflow (reduce the rate of accumulation of external debt) by contributing foreign currency to the foreign exchange market.

This impact does not depend on whether the intervention is sterilised or not. It would be useful, however, to consider the effect of sterilisation. Now
\[ PSBR = \Delta PG + \Delta RBG + \Delta OG + \Delta PGS + \Delta OGS \]

where \( \Delta PG \) = increase in private sector holdings of Commonwealth Government securities

\( \Delta RBG \) = increase in Reserve Bank holdings of Commonwealth Government securities

\( \Delta OG \) = increase in overseas holdings of Commonwealth government securities

\( \Delta PGS \) = sale of other public authority securities to the private sector

\( \Delta OGS \) = sale of other public securities to the overseas sector.

Therefore,

\[
CIF = I + \Delta PG + \Delta RBG + \Delta OG - S + (\Delta FX - \Delta OG) + \Delta PGS + \Delta OGS
\]

\[
= I + \Delta FX + \Delta FG + \Delta OG + \Delta RBG - S + \Delta PGS + \Delta OGS
\]

Now from the balance sheet of the Reserve Bank the change in the money base (\( \Delta MB \)) is given by

\( \Delta MB = \Delta RBG + \Delta FX + \Delta OAL \)

where \( \Delta OAL \) is the net change in other assets and liabilities of the Reserve Bank.

Therefore,

\( \Delta FX + \Delta RBG = \Delta MB - \Delta OAL \)

and

\[
CIF = I + \Delta PG + \Delta OG + \Delta MB - \Delta OAL + \Delta PGS + \Delta OGS - S
\]

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If $\Delta MB = 0$ (i.e. Reserve Bank foreign exchange operations are sterilised)

$$CIF = I + \Delta PG + \Delta OG - \Delta OAL + \Delta PGS + \Delta OGS - S$$

This shows that when foreign exchange market intervention is sterilised, the Commonwealth Government contribution to offshore borrowing is represented by the sale of securities to the private sector as well as the sale of securities to overseas investors and changes in the other assets and liabilities of the Reserve Bank. When there is an addition to the money base, this also leads to an increase in offshore borrowing. Similarly, all other things equal, the domestic sale of other public sector securities also adds to the debt. This illustrates the point that government borrowing tends to add to external debt, even if it is done domestically.