MINING INVESTMENT BOOM: A DOUBLE-EDGED SWORD FOR THE AUSTRALIAN *economy*

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There is a lot of talk about the mining boom in Australia. But as the Federal Treasurer Wayne Swan outlined in his 2001 budget address, it would be more accurate to say Australia is anticipating a mining investment boom, rather than a mining boom.

The additional money the economy can receive from the rise in mineral exports is when banks lend for investment in mining. The more they lend, the greater the investment boom.

In his 2011 budget address, the Federal Treasurer Wayne Swan recognised that "for some, talk of an investment boom seems divorced from reality.[1]" This is because the growth of mineral exports has inflated the value of the Australian dollar, which makes agricultural exports more expensive and has the potential to reduce income in the farm sector. It also raises the price in foreign markets of Australian manufactured products. In addition, it makes imports cheaper, shifting demand from domestic products to imports, which impacts import-competing industries. So while miners may prosper from trade, this dynamic can have a negative impact on other industries.

The silver lining is that mining activity encourages investment in mining. To finance that investment, businesses borrow. To the extent they borrow from Australian banks, they inject additional money into the economy. But even the growth of bank lending has challenges for the economy and for banks.

We know that when we sell products and services we produce, the money we earn enables us to buy an equivalent amount of products and services. In this way, money constrains the nation's expenditure to its income. When banks lend additional money, that money enables the economy to buy more than it has produced.

The only way a country can buy more than it has produced is to import more than it exports. Therefore, the additional money from bank lending causes current account deficits. That relationship is shown for New Zealand in Figure 1.

The part of the current account deficit not financed by selling capital assets must come from foreign debt. People and businesses need money to buy goods and services and service their debts. The growth of both domestic and foreign debt means that people are using a larger share of their money to repay their debts, leaving them with a smaller share to buy goods and services. The reduction in demand for goods and services lowers national income and reduces the capacity of the economy to repay its debts.

Figure 2 compares the growth of bank credit in Australia with the growth of gross domestic product (GDP). It shows domestic debt is rising more rapidly than GDP and confirms that the capacity of the economy to repay its debts is declining.

The risk is that eventually, the economy will be unable to service additional debt. But if the economy stops increasing debt, it stops increasing the money supply and the

Figure 1: New Zealand – Growth of bank credit and the current account deficit

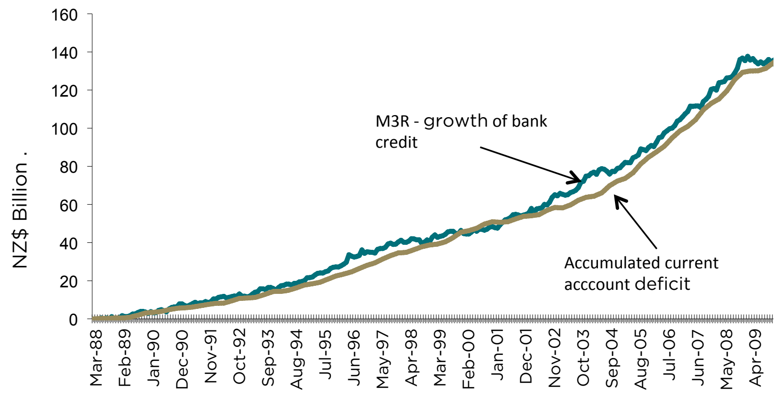
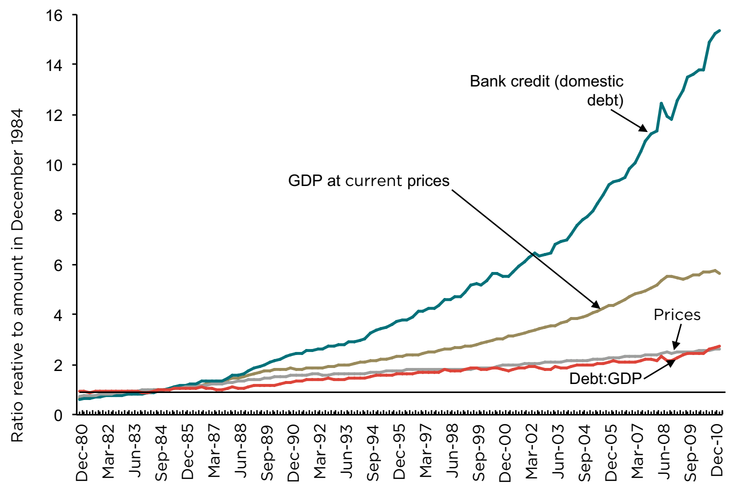


Figure 2: Australia – Domestic debt and GDP



economy will stop growing. Without economic growth, many borrowers may not be able to service their debt. That could lead to a financial crisis of the type experienced in North America and parts of Europe.

To avoid this, the economy needs a source of money that does not raise domestic and foreign debt. It is possible to modify the floating exchange rate system to allow the economy to generate addition money from foreign income. There are two changes required. The first modifies bank lending guidelines. The second modifies the objective of the exchange rate.

The first step is to require banks to hold foreign exchange reserves. These reserves are the foreign earnings of exporters that have been converted into domestic currency. This domestic currency is created without raising domestic or foreign debt. Eventually, the domestic money will be converted back to foreign exchange to pay for imports. While the domestic currency continues to circulate in the domestic economy, the foreign reserves represent the savings of the nation.

If banks lend those national savings without completely depleting them, then they would be lending without raising foreign debt. To achieve this outcome, banks may be authorised to lend up to, say, 90% of the savings.

The second change provides incentives for the foreign exchange market to set the exchange rate at a level that would raise demand for domestic products sufficiently to provide full employment. Banks profit from making loans rather than holding foreign reserves. If bank lending and profits were linked to the level of employment, then they would have an incentive to drive the exchange rate at a level that would achieve full employment. For example, banks may be allowed to lend 90 cents per dollar of savings if unemployment is less than 3%. For every 1% of unemployment above 3%, the amount that banks could lend would be reduced by 10 cents. Thus if unemployment were 5%, banks would be able to lend 70 cents per dollar of additional foreign reserves.

To maximise lending and profits, banks would depreciate the exchange rate to a level that would achieve full employment and raise their foreign reserves. But if the banks were to excessively depreciate the currency it may cause inflation. To avoid this outcome, the share of savings banks could lend may be reduced by an additional 10 cents for every 1% of inflation above the acceptable level of 3%. For example, if inflation were 5% and unemployment 5%, banks would be able to lend 50 cents per dollar of savings.

This approach enables the economy to generate money from national savings, as well as bank lending. It provides a means for the economy to reduce its debt burden and avoid a financial crisis. It is an approach that produces a sustainable finance industry that allows the mining industry to boom and contribute to the prosperity of the whole nation.

Leigh Harkness has been the economist for the Ministry of Finance in Tonga and worked for the Australian Treasury. More recently, he has been consulting, mainly in the utilities industry.

1. Quotation from Budget Speech 2011-12, 10 May 2011.