

Rising Foreign Debt, Slow Economic Growth and High Unemployment: A brief explanation of their cause in Australia and how to overcome them

by Leigh Harkness

Economic theories may appear rational when explained in thick text books. But when they are applied to determine economic policy, they are often found to be defective. If the economic policy based on economic theory brings undesirable outcomes such as slow economic growth, high unemployment and rising foreign debt, we should question the theory as well as the policy. In this article I consider some of my experiences as an economist and present an alternative theory to explain the performance of our economy and what can be done to rectify our economic problems.

Foreign debt

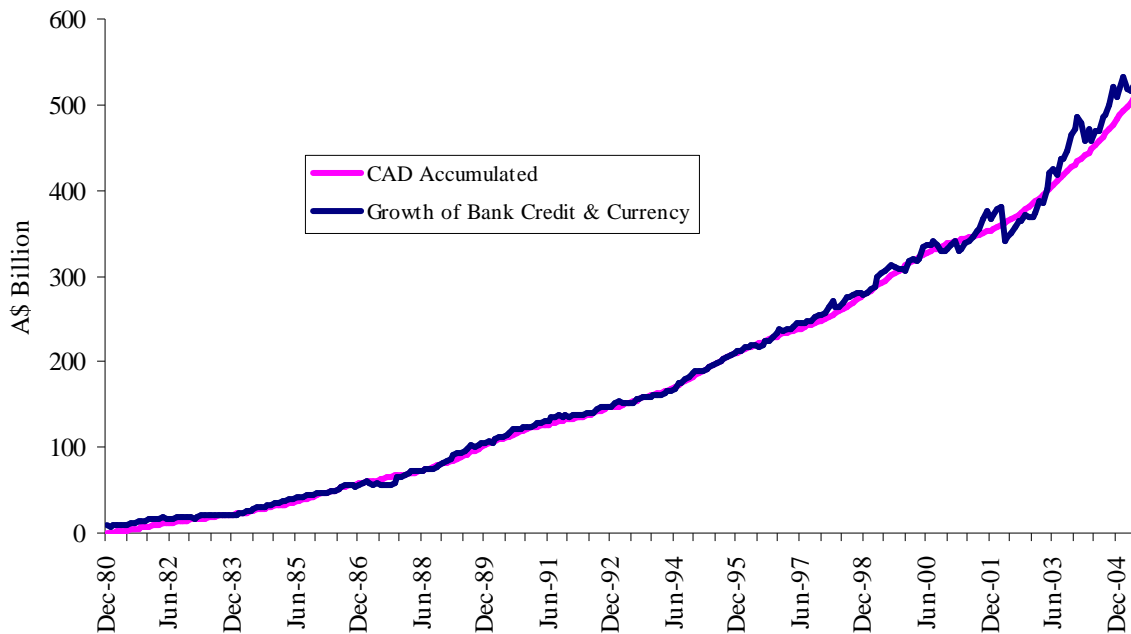
In December 1981, the Ministry of Finance of the Kingdom of Tonga implemented a policy to control the balance of payments that proved remarkably successful. I was the economist for the Ministry at that time, responsible for both fiscal and monetary policy. We found that the source of the falling foreign reserves was a rise in bank lending. Westpac had sent a new bank manager to Tonga to manage the Bank of Tonga. He believed that the Bank should do more for the development of the Kingdom and increased bank lending. In this small economy, the creation of this additional money increased imports. Hence foreign reserves declined.

To address this problem, we advised the Bank that it could lend as much as it wished while foreign reserves were greater than the equivalent of 6 months imports. However, if foreign reserves were to fall below that level, it was required to use its discretion to restrict lending. If reserves were to fall to 3 months imports, it could lend only what was repaid in loans. If reserves were to fall to 2 months imports, it was to stop lending.

In March 1982, Tonga's main export industries were devastated by Hurricane Isaac. Yet, Tonga did not have any balance of payments problems. The guidelines had proved effective.

In July 1984, I joined the Australian Department of Treasury. At that time Australia had a problem with its current account deficit. Out of curiosity, I investigated whether the cause of the problem in Australia was similar to the cause in Tonga. The following graph (updated to current data) reveals my findings.

Australia: Bank Credit and Current Account Deficit



The graph compares the accumulated current account deficit with the growth of bank credit (including bank bills) and the issue of notes and coins. The graph shows that the current account deficit is approximately equal to the growth of the money supply from these sources. This finding is consistent with what we had found in Tonga.

The way money works in the economy is that when producers sell their products, the money they earn enables them to buy products up to the value that they produced. If all money were earned from production, nation could never buy more that it produced. In that case, it should never have balance of payment difficulties.

Individuals can increase their spending above their income by borrowing from other people. However, when people lend money, they must reduce their spending to let the borrower increase their spending. Therefore, private lending cannot increase national spending above national income.

But when banks increase their total lending (above loan repayments), they do not reduce anyone's spending to compensate for the increased spending that they are financing. Increases in their expenditure cause national spending to exceed national income. That is, the growth in bank lending causes the nation to buy more than it has produced. It is this that causes current account deficits.

Current account deficits can rise, also, if governments print more money and use it to finance their spending. However, only 6% of the money shown in the graph for Australia can be attributed to the increase in notes and coins in circulation. It is the growth of bank credit that is responsible for most of the growth in the money supply and, therefore, for most of the current account deficit and the foreign debt.

We found in Tonga that money that comes into existence from increased exports is not a problem. It comes into being by increasing foreign reserves. When that money is eventually

spent on imports, it does not pose a problem. The imports can be paid for with the foreign reserves that were increased when the money first entered the economy.

The broad economic principles behind this is that when exports increase the money supply, that money comes into existence because income (from exports) is greater than spending (on imports). On the other hand, the money created from increased bank credit causes spending to be greater than income. The policy of regulating bank lending in Tonga balanced these two sources of money to ensure that national spending did not exceed national income. This policy enabled the economy to maximise its spending and income without causing balance of payments problems.

My colleagues in the Australian Treasury did not welcome my findings on the relationship between the growth of bank credit and the current account deficit. The government had deregulated bank lending in July 1982 and the Treasury did not want to see any data that might question the wisdom of that policy. The Treasury tried to discredit the relationship between monetary growth and the current account deficit calling it a “coincidence”. But what was in 1988 an \$82 billion coincidence has persisted for a further 17 years to become a \$500 billion coincidence.

The Treasury dismissed as inappropriate the economic principles derived from the successful policies I had implemented in Tonga. They said the policies were appropriate for small island economies only. But since then, it has been the Australian Treasury’s principles and policies that have proven to be inappropriate, as they have been unsuccessful.

The floating exchange rate system

One of the main reasons the Australian government gave for floating the exchange rate in December 1983, was to control the balance of payments. However, Australia’s current account deficits have persisted regardless of the exchange rate. As we found in Tonga, the current account deficit is largely caused by excessive growth in bank credit. So what has been the effect of floating the exchange rate on the economy?

The floating exchange rate system requires the exchange rate to vary to ensure that foreign receipts equal foreign payments. This is achieved on the foreign exchange market. Traders holding domestic currency and wanting to buy foreign currency are required to exchange their dollars with other traders holding foreign currency and wanting to buy domestic currency.

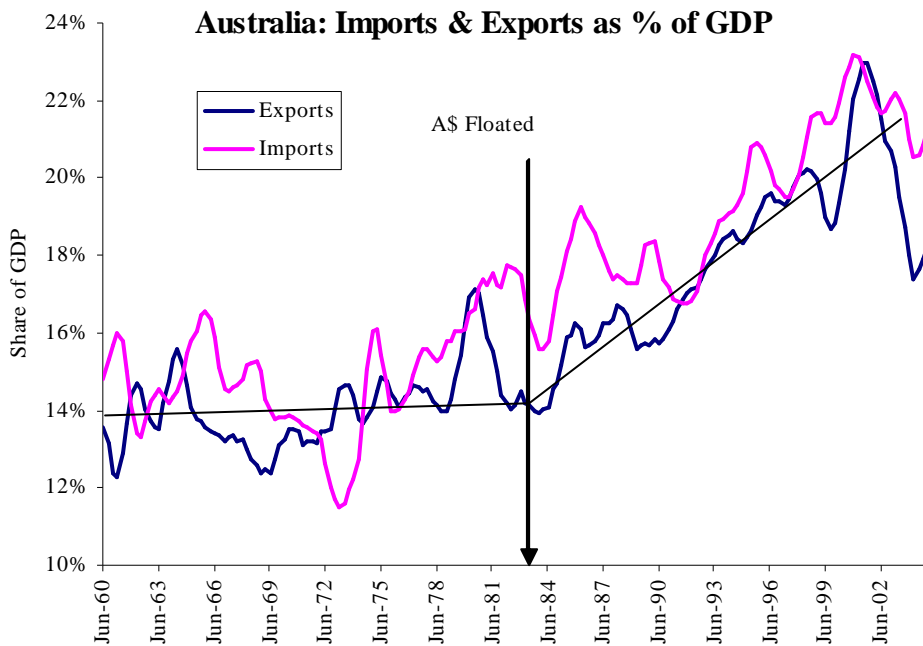
Under the fixed exchange rate system foreign money entering the economy could increase the money supply. But under the floating exchange rate system, this is no longer possible. The foreign exchange market allows foreign money to be exchanged into local currency but prevents foreign currency from increasing the money supply. Thus, the floating exchange rate system has eliminated the one source of money that came about because income was greater than spending.

Therefore, the introduction of the floating exchange rate system left the Australian economy with bank credit as the main source of monetary growth. Without the money from exports to balance it, all growth in bank credit is excessive, causing national expenditure to exceed

national income. It generates current account deficits and increases foreign debt. This has been Australia's experience since the float.

Slow economic growth and unemployment

Another effect of the floating exchange rate system is revealed in the following graph. The graph plots exports and imports as a percentage of gross domestic product (GDP).



Before the float of 1983, any increase in exports would inject new money into the economy and raise national income. The increased income would raise spending on (demand for) Australian products and create more jobs. Spending on imports also increased. However, the graph reveals that before the float, spending on imports was a relatively stable share of income. Total spending on imports increased only as national income increased.

After the float, the graph shows that imports increased dramatically as a share of GDP. This is because the floating exchange rate system generally requires imports to rise when exports rise to provide more domestic currency to the foreign exchange market. Australian exports continued to increase after the float. But rather than increasing incomes, the exports inflated the real exchange rate and increased imports. To achieve this, Australian spending had to shift to imports and away from Australian products.

Thus any increase in exporters incomes brought about by the increase in exports was immediately offset by a reduction in the incomes of import competing industries. Raising exports no longer increased national income and employment.

Also, the fact that spending on imports in Australia increased as a proportion of GDP means that the exchange rate must have appreciated in real terms (to make imports relatively cheaper than domestic products). The higher real exchange rate has reduced the price that exporters receive in Australia for their exports. That has reduced their incomes. This is particularly

evident in farm incomes. Australian farmers have suffered a substantial loss in their incomes because of the floating exchange rate system.

During the 1960's, Australia doubled its exports and its national income. This was a period of rapid economic growth and high levels of employment. Australian exports have again doubled in the last ten years, but under the floating exchange rate system, national income has increased by only one third. This lower rate of economic growth is directly attributable to the introduction of the floating exchange rate system.

International experience

Australia is not alone in suffering the problems of slow economic growth, high unemployment and rising foreign debt associated with the floating exchange rate system. Europe and North America have had similar experiences. Europe is trying to deal with the problem by establishing a common currency.

More recently, deregulation of financial markets and the introduction of the floating exchange rate system in countries in South East Asia has:

- slowed their rate of economic growth;
- increased their current account deficits to unsustainable levels;
- caused economic instability; and
- raised unemployment.

The IMF is sponsoring a program of fiscal restraint and monetary reform in the region. However, these policies are unlikely to bring about a return to economic prosperity.

Japan is a net exporter of capital and has done better than most under the floating exchange rate system. Its capital exports have deflated its exchange rate, making its products internationally competitive. However, even its rate of economic growth has fallen dramatically since it floated its exchange rate and it is now experiencing rising levels of unemployment.

The optimising exchange rate system

It is possible to overcome these problems associated with financial deregulation and the floating exchange rate without directly regulating the monetary system and without returning to the fixed exchange rate system. This method is in two parts:

- the first part manages the growth of bank credit to avoid balance of payments difficulties; and
- the second part manages the exchange rate to ensure that spending on domestic products is sufficient to provide full employment.

This may not be the only solution. When other economists become aware of the nature of the problem they may be able to develop better solutions. However, at this time I am not aware of any other solutions.

To consider the first part of the solution, it is necessary to initially assume that the exchange rate is fixed. This part requires all banks to hold foreign reserves and to regulate their lending according to the rise in their net holding of foreign reserves. For example, banks may be

authorised to lend, say, A\$10 for every US\$1 increase in their net foreign reserves. As in Tonga, this requirement ensures that the banks cannot lend the country into balance of payments difficulties.

The second part of the solution modifies the first part to motivate the banks to push the exchange rate to a level that would provide full employment. Let us assume that the exchange rate is now variable and set in the market. Also, to illustrate the system, we will assume that full employment exists when unemployment is two percent or less.

In this second part, the banks' are again authorised to increase lending by A\$10 for every US\$1 increase in their foreign reserves but only while there is full employment. If unemployment were greater than two percent, the banks' authority to lend would be reduced by, say, A\$1 for every one percent of unemployment above two percent. For example, if unemployment were 5 percent, the banks would be authorised to lend A\$7 for every US\$1 increase in their net foreign reserves.

This requirement motivates banks to push the exchange rate to a level that would make domestic products sufficiently cheaper than imports that spending on them would be sufficient to provide full employment. Banks are motivated to do this because they can maximise their lending and their profits only when there is full employment.

If changing economic circumstances affected employment, the banks would be free to adjust the exchange rate to maintain full employment. Note that under this system, the exchange rate would be much more stable than under the existing floating exchange rate system.

This, the optimising exchange rate system would ensure that:

- the exchange rate was flexible (yet more stable than we have at present);
- the nation did not have balance of payments difficulties; and
- there was full employment.

Under this type of monetary arrangement, an economy could become prosperous.

Attempts to bring about full employment and economic prosperity to an economy without removing the deficiencies of the floating exchange rate system can only result in failure.
