# DEPRESSION OBSERVED

## LESSONS IN A BACKWARD GLANCE

by *MAXIMILIAN WALSH*

***Two major depressions have punctuated the past 100 years of Australia's history. For those who believe that history repeats itself, those episodes provide food for thought.***

Those of you who are fresh graduates of the Securities Institute courses are probably anxious to dive into the rip-roaring stock market and make your first million — if you haven't already done so. Reading that pertinent daily social comentary, Doonesbury, I see that if you haven't made your first million in the financial markets by the time you are 30 you are a failure.

My, how things have changed. Or have they? I remember the disbelief with which I first read of the South Sea Bubble, when English investors were tripping over themselves to invest in companies created for the most incredible purposes — indeed, the most quoted example was a company floated for a purpose to be decided later. Nowadays we call such companies cashbox companies and Australian investors are flocking to them.

My message is a relatively simple one. Indeed, Henry Kaufman recently put it in one line. Henry, who is also known as Dr Doom, has for years been the top economist at Salomon Brothers on Wall Street. At the end-of-the-year bonus time he told his partners: "Enjoy yourselves now. Soon you will have to work for a living."

I will take a little longer but the message is the same. Leafing through the Securities Institute 1987 handbook I noticed that none of the various units to be taken seem to cover economic history. In a way that's probably just as well; the drop-out rate might be higher. But a brief backward glance can be helpful even when we are travelling forward at a million miles an hour. Since the end of transportation — that is, the enforced population of Australia with convicts — Australia has had two major depressions. The first was in the 1890s, the second in the 1930s. This latter one, known as the Great Depression, was a global affair. But in the 1890s, with only modest help from overseas, we managed to have a depression almost by ourselves. The two depressions shared a number of characteristics, the most important being that both were preceded by a fall in the terms of trade. This fall was not an overnight affair. In fact, rather like the fall in the terms of trade you hear so much about at the moment, it occurred over about 10 years.

Our own terms of trade have been falling fairly sharply — except for a flattening-out in the middle of the period — since 1973.

The decades before the 1890 and the 1930s depressions also shared the characteristic that the downturn in the terms of trade was disguised by heavy overseas borrowing.

For those of you — if there are any — who feel history does sometimes repeat itself, the 1890s depression offers food for thought. The terms of trade began to move against us about 1880. But this was not noticed for some time because the colonies at the beginning of that decade went on a borrowing spree. They were

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building railways in much the same way as we went on a power-station-building spree in 1980.

However, the flow of funds was helped by — you guessed it — a stockmarket boom. Mt Morgan mine was discovered in 1882 but the really hot stock of that decade was The Broken Hill Proprietary Company. It was floated in 1885 with its shares selling at 9 pounds each. By 1887 they had risen to 176 pounds and by 1888 to 223 pounds.

Eighteen eighty-eight was the year in which the capital inflow peaked. It was an interesting year in other ways. In Queensland, which even then was considered the most conservative colony, a new political movement was created. Its founder was a charismatic character called William Lane. He wrote, incidentially, under the *nom de plume* The Rambler.

The party Lane founded was the Australian Labor Party. It contested four seats at the Queensland election, winning none. The Joh party at least won one in its first election in the Northern Territory.

Lane became disillusioned with the party he had created and with a band of disciples sailed for Paraguay. I am not sure that we will see a repeat of that.

The most populist issue of the day in 1888 was taxation. The American Henry George drew huge crowds with his advocacy of a single tax system based on land. Tax was such a burning issue because of the growing disparity in the distribution of wealth. Not unlike Australia today, we then had the situation where the average worker was receiving little in the way of real wage increases while the stockmarket, populated by some very conspicuous consumers, was booming.

Even more popular than silver were the land companies. Where these days we have our Elliotts, Bonds, Murdochs and Holmes a Courts tapping the Eurobond markets for millions, in those days we had such names as Baillieu, Fink and Munro dragging in millions from land banks they opened in London, Edinburgh and Glasgow.

That speculative boom was beginning to collapse under its own weight when the flow of funds was cut with the news that the large British bank Barings — you might call it the Citibank of its day — was in trouble because of defaults in Argentina. The local banking industry took a particularly hard hammering because overexposure in the property market was compounded by market rigging.

As a matter of record, some 35 members of the stock exchange in Melbourne, which is those days was indisputably the financial capital of Australia, became insolvent because of their land and share dealings.

Other brokers took a shorter cut to the solution of their worldly problems. Charles E. Broome, insolvent stockbroker, of Elwood, poisoned himself with prussic acid. Another, George Ford, stabbed himself 15 times in a room at Scott's Hotel and bled to death. A bankrupt mining speculator, William James Irwin, walked in broad daylight to the Yarra near Princes Bridge, deliberately took off his hat, coat and vest, waded in and was drowned.

The annual report of the Melbourne Stock Exchange of October 1893 carried the observation: "The depression has brought with it much that will have a lasting and beneficial effect on the future of the colony. . .we are sanguine that the dark days are over."

In fact, it took another four years' hard work for the colonies to put their houses in order. This process was assisted considerably by mass migration out of Victoria, mainly to the new gold fields of Western Australia and the new copper discoveries in Tasmania.

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The 1920s were not as hectic as the 1880s but they were not dissimilar. While we did not have a raging stockmarket boom in the twenties, the share price index doubled. In New York it nearly quadrupled during that bull market to collapse by 1932 to half its level of 1920. The value of shares in 1932 was, in fact, just one seventh of what they had been on Wall Street three years earlier.

Inflation in that part of the economy we usually measure — wages and prices — takes some time to wring out of the system. Inflation in financial instruments can be and has been stopped overnight.

But to return to Australia in the twenties: we again had the terms of trade move against us and again we sought to borrow our way out of trouble.

In preparing these notes I came across a Reserve Bank publication entitled *The 1930s and the 1980s — Some Facts.* The paper was published in September 1983 with the purpose of rubbishing those commentators, myself included, who felt that there were lessons to be learnt from the earlier episode which were not appreciated by the government or those advising the government.

The event which focused attention on the situation was the threatened default in 1982 by Mexico on its foreign debt. This exposed to the world both the extent of developing-country debt and the imprudent behaviour of the major money centre banks in their rush to recycle petrodollars.

Since then the international debt situation has actually deteriorated despite the soothing noises made by the banking system. Brazil defaulted on $68 billion of debt on February 20 and this action could cause a domino of defaults. The proportion of developing country debt to the capital base of the major money banks is a matter of increasing concern because it is evident that we cannot return to the global growth rates of the sixties until the debt problem is solved. Not only are we locked into an international low-growth situation. We are constantly on the edge of global recession, or even depression.

Lest anybody think that this is scare talk, let me make the simple observation that some countries are in a depression as great as that endured in the 1930s. The real income per head of population in Mexico currently stands at 40 per cent below what it was in 1982 — that is depression in anybody's language.

But to return to our own Reserve Bank. It published this discussion paper

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in September 1983 to reassure all that we were not in for a repeat of the twenties and thirties. The conclusions of that Reserve Bank paper began with the statement that in comparing the 1920s and 1930s with the 1970s and 1980s it is quickly evident that there are similarities and differences. Both periods saw a sharp rise in unemployment. That remains true down to today. In fact, since 1983 unemployment in Australia has remained high but it has not moved upwards significantly. While unemployment has remained static during a period of modest growth in output — growth largely confined in the last 12 months to the capital-intensive export area — it does seem that the major factor has been lower real wages.

If that is the case, and few would argue that that is probably the case, then we are in for an increase in unemployment because the recent national wage case signals the end of real wage decreases. Unemployment in 1928 was around 8 per cent — just about where it is now.

The next point of difference identified by the bank was that prices were generally falling in the 1920s and 1930s while most prices have risen — in some cases by a large amount — in the 1970s and 1980s.

It is true that we still have rising prices here — in fact, we have inflation of the order of 10 per cent. But we are out of step with a world that has moved from disinflation (falling inflation rates) to deflation (actual price falls).

Our inflation rate is a matter for concern, threatening, as it does, continuing high interest rates and low investment. Also, in the interests of historical accuracy, it should be observed that prices did not fall in Australia until 1929 with the actual onset of depression.

The next paragraph in the Reserve Bank's conclusions reads: "World trade fell much more severely from the late 20s than seems likely in the current episode. The rise and fall in Australia's terms of trade was much larger in the earlier episode. While Australia is still a small open economy its economic base is now much wider; also the external shock has been much smaller in the current episode."

My response is that the decline in world trade did not take place until 1929 with the onset of depression. Figures released last week by the GATT organisation suggest that world trade is slowing almost to a standstill. The decline in Australia's terms of trade in 1983 might compare favourably with the experience of the 1920s. That is no longer the case — falling commodity prices, depreciation of the currency and higher prices for manufactured goods provide an entirely different profile to our terms of trade than that which existed a mere two years ago.

And I would quibble with the claim that Australia now has a much wider economic base than it did in the 1920s. We remain a commodity-exporting nation. In the twenties the main exports were wheat, wool and gold. Today coal has replaced gold and while the list of exports is larger it is, if anything, more closely tied to the commodity cycle than it was in the twenties and thirties.

The next point made by the Reserve Bank was this: "Overseas borrowing in the 1920s was on a much vaster scale than in the 1970s. The debt-servicing burden is consequently much smaller in the 1980s than it was in the 1930s. Also in the late 20s capital inflow dried up, forcing large adjustments to eliminate current account deficit, whereas in recent times capital inflow has tended to exceed the large current account deficit."

According to the Reserve Bank's figures the interest in Australia's overseas debt as a proportion of export receipts peaked at 29.4 per cent in 1930-31.

In 1985, when our net foreign debt was $52 billion, interest as a percentage of exports was 11 per cent. Currently our net foreign debt stands at $80 billion. No official figures are available on interest as a proportion of exports but if we reckon interest at 10 per cent — which would be a conservative estimate of the hedged interest cost — then interest as a proportion of exports is more than 20 per cent.

Now while that is better than 29 per cent, two points should be made. The figure has doubled in a mere 18 months, Second, most of our 1920s debt was long-term. Most of our present debt is short-term and amortisation plus interest produces a much higher result than was the case in the thirties.

Dominguez Barry Samuel Montagu recently did a back-of-the-envelope exercise on our debt-servicing costs and came up with a figure of 68 per cent of exports — a figure it conceded was probably nonsense but a figure which would put us firmly in the Latin-American class.

The other point to remember is that in 1930-31 the Australian balance of payments had moved into surplus on current account. We are now running a current account deficit that is above 5 per cent of GDP — and this is a country which exports a little over 15 per cent of our GDP. To balance our current account and merely hold our debt at its present high level would require an increase in exports of more than 30 per cent.

Now we can achieve the same result by other means — by reducing internal demand, for example. That brings up the subject of fiscal policy and the nasty world of politics. I have probably depressed you sufficiently without going down that track.

With a combination of political courage at home and abroad, a lot of luck and a return to prudent behaviour in world financial markets, we can avoid a recession. Such a quadrella is possible — but I agree with Henry Kaufman that the odds are long.

My advice is to get out there and make your first million quickly. Time is running out. □

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