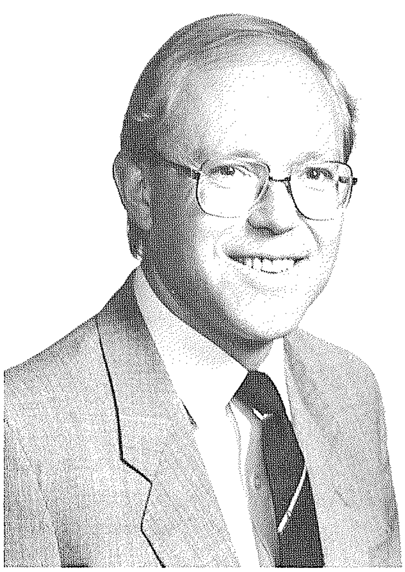
FOREIGN DEBT: CAN WE COPE?

AUSTRALIA'S GROWING BURDEN OF BANANAS



by ALEX ERSKINE

The tyranny of foreign debt casts a lasting shadow over the Australian economy. Continued international liquidity is crucial to the health of the financial sector.

At the start of this financial year, Australians had gross external debts of $A137 billion, or the equivalent of 167 million tonnes of bananas at the price ruling in 1988-89. The rapid rise of external indebtedness and the high levels of debt in relation to the size of the economy ensure that the 1990s will be a decade full of problems – for economic managers and for financiers as well as for the community. It is very difficult to achieve strong economic growth and repay external debt at the same time, and yet if we don't find a way to do so, growth must slow to a crawl – or worse.

I regret that it seems to me that the risks posed by this heavy burden of external debt do include the threat of a systemic financial sector failure, and more certainly considerable pressures on individual institutions, even though such failures can – and I hope will – be avoided.

This paper is intended to explore what has happened, what the growth of external debt has meant for the financial sector and its clients, and the consequences of what is likely to be done to bring external debt back under control. Examples from overseas will be drawn on, though it is clear that each debtor, including Australia, faces special circumstances and has to be treated as a unique entity. There are implications aplenty for the financial sector. My approach is shaped by my natural inclination to be a killjoy. Until recently I would have feared that raising these topics might have had me branded as outrageous or irresponsible, but Mr Keating has done much recently to highlight the "tyranny of debt" that confronts us.

I have a suspicion – until it is proven otherwise – that "the existence of great. . .debts is a menace to financial stability everywhere," to quote Lord Keynes (1919). I would be delighted, but quite frankly amazed, if anyone could persuade me that the present $16.4 billion current account deficit over the twelve months to April and the most recent ten annual current account deficits are entirely the result of virtuous events, such as a sudden boost to productivity that forced Australians to invest at a rate faster than could be financed by domestic savings. Some part of the latest year only, perhaps.

Instead, I suspect the age-old explanations of an excess of domestic consumption, an unwillingness to persist with stringent measures, and too little done too late to boost productivity, must take the major blame for the growth in external debt. Being based largely on enhancing an already-high standard of living is what makes the growth in our external debt look so dangerous.

Maintaining international liquidity — access to foreign savings to roll over and refinance debt and to be able to

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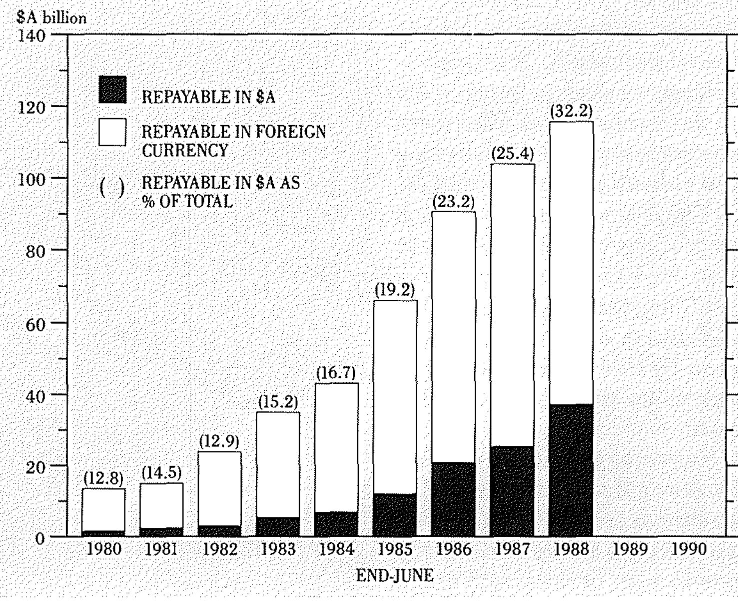
borrow more – is going to be the key: if we lose that, the tyranny of debt becomes not just running faster to stand still, but chronic atrophy of the economy.

Turning first to an assessment of where we are, it is pertinent to start the story in 1984. This was the year that many of the more farsighted observers became alarmed at the increase in Australia's external indebtedness. To be sure, the problem was not generally recognised until 1986 but since then it has been rare for an economic policy statement from government not to address itself even obliquely to the need to slow the growth of external debt.

What has been achieved? On my calculations – and using the Australian Bureau of Statistics definitions as the relevant measures – Australia's gross debt has more than tripled over the five years since 1984 and the net debt has grown a little faster.

Gross external debt



Even after the general recognition of the problem and the continual orientation of policies to slow debt growth since 1986, gross debt has risen by 50 per cent during the latest three years – a slower pace of growth but nothing to be complacent about. As an absolute amount, Australia's gross external debt ranks high in world terms. At around $US110 billion, it is below the US's half-trillion but similar to Mexico's $US107 billion and Brazil's $US124 billion of debts that have been rescheduled.

I mentioned the qualification that I was using ABS figures because not everyone counts external debts in the same way. The Institute of International Finance in Washington considers that the ABS figures understate short-term external debt, and to make the point includes in the IIF estimates the ABS figures for accounts payable and interoffice credits, and insinuates that other short-term trade credits have been under-counted. BIS figures commonly reported in the media only relate to loans by BIS-area banks. US banks seem to be responsible for a very modest part of Australia's total indebtedness, by the way.

Of more relevance than the absolute dollar value is the debt as a comparison to the size of the economy, and it is here that some observers find solace. As a percentage of GDP, Australia's net debt has stabilised temporarily at a high 30 per cent – although this is set to increase to around 34 per cent of GDP or more if you heed the medium-term debt stabilisation scenarios prepared and recently recast by the Office of EPAC.

This early, though temporary, stabilisation, and the fact it is at lower levels than originally expected, is the result since 1986 of the quite fortuitous rise in commodity prices and the $A, the fall (now reversing) in the $US and the otherwise regrettable fast rate of inflation in Australia, as well as the more virtuous things, such as the achievement of rapid economic growth and the modest (and temporary) diminution in the size of the current account deficit in 1987. All the debt and debt-service ratios – to GDP, to exports of goods and services, the maturity structure of the debt – have appreciably worsened, despite almost everything running in Australia's favour.

The growth in external debt has been intimately bound up with the expansion of the financial sector. Cause and effect are hard to disentangle. It is clear that the growth in external debt has gone hand-in-hand with very rapid credit growth.

Credit extended by financial intermediaries to the private sector has increased by almost 150 per cent over the past five years, or an average of 20 per cent a year. The increase has summed to $162 billion, against which the $93 billion increase in gross external debt pales by comparison. However, the external debt has certainly greased these wheels, lubricating the $50 billion growth in bank bills outstanding in particular. To some extent this was a product of a clumsy tax – the SRD ratio.

The Reserve Bank reports that $25 billion has been borrowed offshore by banks and non-banks for on-lending to the private sector. Not surprisingly, the finance sector has had a wonderful five years, but much of the growth and the champagne has been the product of Australians borrowing more from abroad and so will come to an end as external debt growth slows.

Just to get orders of magnitude into perspective, it is worth considering that the stock of foreign debt is almost exactly equivalent to the entire money supply on the M3 definition; that is, all the notes and coin in circulation in Australia plus interest and non-interest-bearing bank deposits held by the non-bank private sector.

There is a chicken and egg problem in the growth of external debt. We know there is a shortage of domestic savings, and the current account deficit – and in turn the accumulation of external debt – reflects this shortage.

It always seems a good question to ask why this shortage of domestic savings has developed. The popular answer is that it is a rational response to a taxation system which taxes nominal interest instead of real interest. A less popular answer, but one which I consider ultimately more important, is that inflation has been too high. Get inflation to zero and the present tax system would then look pretty OK and there would be an incentive to save.

But the finance sector is not blameless. For ages the finance sector was remarkably inefficient at its job of intermediation, and penalised lenders unduly. The growth in external debt does reflect poorly on the financial sector which could have played a more efficient role in mobilising domestic savings.

Oligopolistic banks stood between depositors and borrowers and were able to charge a very wide spread in order to cover bloated overheads. Borrowers – generally large – could go overseas for funds, so the banks had to offer them competitive rates. But depositors, lacking choice and individually small, could be exploited. The 3¼ per cent savings bank book – the joke book that lasted for more years than we care to remember – was a great instrument to discourage savings. Of course, some blame must be shouldered by those who hamstrung the finance sector with regulations that raised costs.

Injecting competition into deposit-taking by deregulation and letting in foreign banks has certainly gingered-up the domestic banks and forced them to pay depositors an interest rate much closer to what borrowers are charged. This pressure for a narrowing of margins will not go away and will over time increase incentives to save. So deregulation and admitting foreign banks were the sort of micro-economic reform that Australia requires to get on top of the debt problem . . . just as important as stripping out inefficiencies on the waterfront etc.

But the failure to efficiently mobilise savings is a lost opportunity for which the finance sector may yet pay dearly, if the measures taken to slow debt growth are as painful as I fear they may have to be.

Our debt ratios are high even though commodity prices have gone our way.

The best way I have found to illustrate the impact of commodity price changes on the amount of external debt that Australia can bear is to convert the debt into tonnes of bananas.

In terms of Australian dollars, external debt has more than tripled in five years, to $137 million, and will rise to an estimated $150 million in the next year.

But in terms of bananas, the debt has only doubled, because the price of bananas has gone up by almost 50 per cent. So we now owe the equivalent of 167 million tonnes of bananas, only slightly more than double the 75 million tonnes owed in 1984. In fact, and because banana prices are forecast by the Bureau of Agriculture and Resource Economics to rise further, the debt in the 1990 financial year should show only a modest increase to 172 million tonnes.

That's the good news: we've had commodity prices running in our favour, so far. The bad news is that if the price of bananas fell back to the 1984 level, next year Australians would owe not 172 million tonnes of bananas but 257 million tonnes, and to service that debt we would have to squeeze our living standards unmercifully. The present level of external debt does make the Australian economy more exposed to commodity price swings. We are going to have to produce more (and probably consume less) to service the debt.

"So what!" you still might say. We ought to be able to squeeze without hurting the finance sector, you might think.

There are indeed plenty of examples from around the world of financial systems that are perfectly secure despite the country's debt burden, and there are examples too of financial sectors that have been seriously weakened without external debt playing a significant part.

However, I don't think it is reasonable to expect plain sailing. I am certainly not criticising the Reserve Bank's prudential supervision, though I am concerned with the authorities who have pursued economic policies that led to Australians becoming "overborrowed". In fact, as I will try to explain, I think prudential supervision is acting in an exemplary way, by *not* totally sheltering the individual financial institutions from the risks that reflect their business decisions.

Letting badly run financial sector players lose money and sell out or go bust is the best boost to financial responsibility you can get.

The greatest risk lies with a sharp fall in commodity prices – say, a re-run of the mid-1980s. Imagine what will occur, and consider whether the financial system can emerge unscathed.

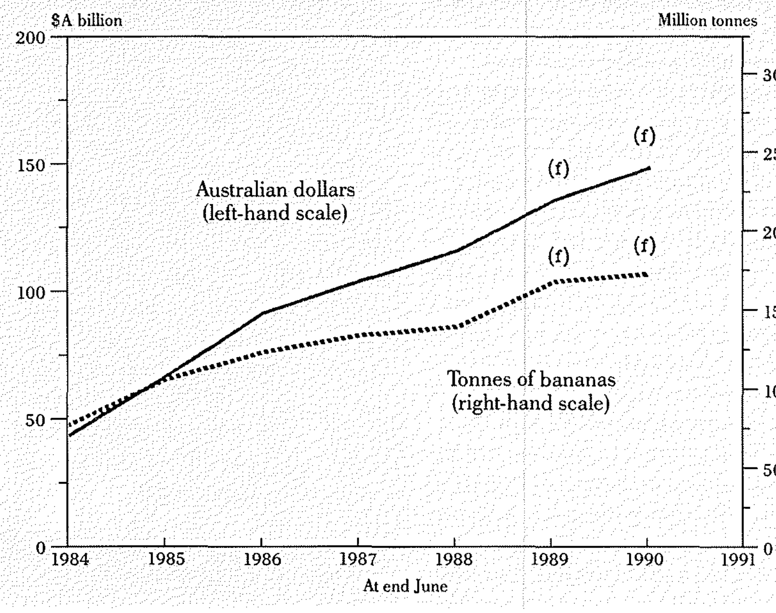
The real debt burden will rise. The usual remedy – a large fall in the $A – will have a very diverse impact across the economy, with great benefit flowing to exporters but big costs being inflicted on importers and those with unhedged foreign-currency borrowings.

That some financiers, along with their clients, will be badly damaged is a reasonable guess. Because a large fall in the $A would push up import prices, we can be pretty sure also that either wages will have to fall sharply in real terms (as in the mid-1980s) or that interest rates will increase; probably both will be required. This spreads the pain into the domestic economy.

In my view, the deleterious effect of a falling $A on the Aussie dollar value of Australia's external debt will limit the amount of devaluation the authorities could opt for – because the valuation effects on the debt outstanding make devaluing almost totally counter-productive. Therefore more of the pain from a decline in commodity prices would have to be borne by the general community in the form of self-administered reductions in living standards.

Be that as it may, on the assumption that commodity prices will decline, there is a significant danger both that the $A may fall sharply and that interest rates may have to move sharply higher – perhaps to levels that the community feels are intolerable. Negative economic

The Banana Republic – gross external debt valued in:



growth is, regrettably, one of the hazards.

The question then arises – how would the authorities respond?

Let's quickly dispense with one old wives' tale. It doesn't matter if the external debt was borrowed by the public sector or the private sector. This is borne out by the experience of those Latin-American countries that started with the private sector doing the borrowing. Too grand a set of private-sector ambitions that ultimately are not matched by the cashflows to service the debts in adverse times is just as difficult for the community to cope with as having governments borrow the money and spend it on grandiose buildings. The consequences are no different, and in fact the cause – macro-economic mismanagement – generally the same.

The collapse of the Alfa Group with borrowings of $US2.3 billion in Mexico in late 1981 particularly underscores the intensification of credit problems which generally accompany a deteriorating country situation. The magazine *Euromoney* was right to predict that after Mexico, banks will be less willing to distinguish between public and private-sector loans. However, the Australian debate has persisted in distinguishing the two. You should be very careful if you do.

Irrespective of whether the external debt originated in the public sector or the private sector, the critical factor is that *if* the community decided not to accept the market penalty for some Australians having borrowed too much (because everyone would be under great liquidity pressures), its final resort is exchange controls and official rescheduling.

This would be "a fate worse than debt", to pinch the title of a recent Third World-leaning book by the economic journalist Susan George. Financial activity would grind to a halt.

This sort of government intervention would inevitably lead to the re-regulation of the financial system and all the economic inefficiencies and welfare losses that would entail.

The first thing to do is obviously to lobby government and the community to be tougher, sooner, in trying to bring the pace of debt growth down, even though that creates unpopularity.

Were the government to listen and implement more restraint now, the climate for business might be quite unpleasant in the short term. Consider that a sort of insurance premium paid for long-term benefits. But it is quite clear that the finance sector would need to take defensive action so that it didn't become too weak in the face of the policy-tightening.

Second, since it is better to have the market sort out the problems created by higher interest rates and a low currency – if necessary supported by the Reserve Bank creating orderly conditions – than to leave the problems to accumulate to a point where the difficulties are systemic, we'd better all get on with it. So I find it encouraging, in a perverse sort of way, to read of the red ink incurred recently by some players in the finance sector. It may breed more caution in the future.

To rub in the dangers, it is salutary to see what happened to financial players in four different debtor countries at moments in their debt crises. Korea, Venezuela, Chile and New Zealand are my examples. The literature is generally rather incomplete and difficult to get at and I think the stories I relate are just the tip of an interesting iceberg.

Korea

In Korea, a country which has seemingly now escaped from its debt burden, the financial sector suffered acutely over a long period at the start of the 1980s. Korean external debt exploded because of the rise in international interest rates and oil prices in 1979, and because of a domestic drought and political turbulence. Inflation increased, eroding competitiveness because the exchange rate was fixed.

For a few months in 1980 very stringent financial policy was pursued after the won was devalued, but had to be eased in the face of a 5 per cent fall in GNP. Money and credit growth slowed sharply after a 4-6 per cent rate hike, but interest rates were then eased to shore up the financial position of the business sector.

Although the economy thereafter was set to grow out of its debt problems, this was not enough to prevent a second financial-sector crisis in 1982, provoked by a financial scandal in the non-bank financial sector, which also required a policy easing to pacify the panic. Direct credit controls were eventually implemented.

The Korean experience just shows the surprises that might be in store for our financial sector: drought, terms-of-trade declines and failures in the non-bank financial sector all sound rather familiar to Australians.

Venezuela

In Venezuela, the corporate sector and the banks suffered heavily when the bolivare had to be devalued by 75 per cent in 1984 and 93 per cent in 1986. The currency had previously been fixed unchanged against the $US since the mid 1960s, but problems built up in the first four years of the 1980s because Venezuela's inflation outstripped US inflation by 25 per cent.

The fall in oil prices after 1981 didn't help either.

Currency overvaluation is fatal. We seem to have avoided that particular pitfall, by persisting with a more-or-less clean float, but it certainly hasn't eliminated all problems.

Chile

In Chile, inflation had become endemic by 1975, and the authorities had responded by indexing almost everything that moved – including interest rates. Unfortunately, different indices that rose at differing paces were used, and huge subsidies emerged. The financial system found itself the meat in the sandwich.

Unable to stand the consequences, the financial system had to be rescued by abolishing indexation for a period and delaying the progress towards reducing debt growth. Chilean debt problems are now into their second decade.

The poor experience with indexation for financial and tax purposes certainly sends out warning signals to countries like Australia tempted to follow along those paths. They can involve very slippery slopes.

New Zealand

In New Zealand, the early 1980 growth in external debt was closely associated with some very questionable lending practices and a huge surge in property and equity speculation. The prescribed cure – the painful application of 20 per cent interest rates for three years, together with an inevitably appreciating currency – made for huge credit losses.

Financial sector giants have been humbled; red ink seems endemic. The economy has been in recession since a consumption tax was introduced in 1987 and the prospect is for only a very drawn-out recovery.

One consequence has been that all New Zealand-owned banks have been for

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BOOK REVIEWS

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interesting collection of material and many analysts and funds managers will find it worthwhile reading.

Economics

By John Jackson and Campbell R. McConnell

McGraw Hill Book Co. $46.95

Handbook of Australian Corporate Finance

(Eds) Robert Bruce, Bruce McKern, Ian Pollard, Michael Skully. Third edition 1989.

Butterworths. $42.50

Reviewed by E. F. GILLIN

For the investment analyst seeking a comprehensive, up-to-date, Australian economics textbook for study or reference, there is not, in my opinion, one more suitable than this third Australian edition of Jackson and McConnell's *Economics*. It is superb.

It developed out of the highly respected and widely used US textbook of Profesor Campbell McConnell of the University of Nebraska-Lincoln. That book has been popular for 15 years or more.

John Jackson of the University of Western Australia wrote the first Australian adaptation, which was published in 1980, and a second revised edition in 1985. Both were well received and widely adopted. This third edition, reflecting McConnell's 10th US edition, is a major revision and up-dating which makes it an optimal textbook specifically keyed to the Australian economy for Australian readers. The coverage, presented in 45 chapters grouped in seven parts, is extensive. All chapters have summaries, questions and study suggestions, selected references and "A Last Word". The excellent graphic and tabular presentations are relevant and the comprehensive index facilitates the use of the book.

In the preface, John Jackson explains: "One thing that remains unchanged (in this edition) is the basic purpose of the text: to introduce the new student of economics to those principles essential to an understanding of fundamental economic problems and the policy alternatives Australian society may use to cope with those problems."

This is a magnificent Australian textbook, well worth the price. It is strongly recommended for all students of economics – secondary and tertiary, as well as for business courses and business libraries, and as a reference book for professional practitioners. Supplementing the main text is a *Study Guide to Accompany Jackson and McConnell Economics Third Edition* by John Jackson and Robert C. Bingham, at $19.95. The guide discusses the main text chapter-by-chapter and for all 45 chapters gives a check list, fill-in questions, problems and projects, and a glossary.

As with the first (1983) edition of the *Handbook of Australian Corporate Finance*, the purpose of this new edition is "to provide an authoritative reference which emphasises the needs of the practitioner while maintaining a scholarly standard of discussion".

Edited by four professionals skilled and experienced in the field of corporate finance, the book's 28 contributions provide explanations and detailed analyses of a relatively full range of subjects important to today's Australian corporations. The fields covered include financial institutions, the securities markets, futures, project finance, trade financing, other corporate debt and equity raisings, mergers and acquisitions, Eurocurrency raisings, foreign exchange, reconstructions and taxation matters.

With financial markets, corporate financing techniques, monetary instruments, business practices and the regulatory conditions constantly changing, it would be difficult to find a more up-to-date, comprehensive, Australian handbook of this type than this excellent, informative and interesting book. As the editors say in their joint preface: "Prior to the first edition of this book in 1983 there was no comprehensive guide to these developments and no single, authoritative source of reference information."

The *Handbook* would be a useful acquisition for any corporate or general library, and it would probably be very valuable to many people engaged in corporate financing, including security analysts. Academics and students in finance and related disciplines could also find it useful. □

FOREIGN DEBT

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sale, and most are now in the hands of foreigners – especially Australians. I guess the Australian buyers are diversifying their risks! The market so far has coped, but there has certainly been blood on the streets.

Looking at Australia, it is hard to not conclude that the New Zealand model is most relevant, even if the Australian economy does have much greater depth. The $A exchange rate has not become excessively overvalued and so sharp unanticipated currency devaluations should be either unlikely or only temporary. However, commodity prices can easily fall and inevitably would push the $A down.

It should be possible even in these circumstances to maintain international liquidity – the access to overseas funds – provided we are prepared to pay the right price in terms of interest rates and policy reforms. So controls – the "fate worse than debt" – can be avoided. But the price will be high.

Obviously, structural adjustment must proceed at a ruthless pace if we want growth to be sustained. Even so, since our debt largely reflects excess demand, and the cure for that is domestic deflation, it is highly likely we will end up with high and higher rates and, to whatever extent possible, even tougher fiscal policy.

The prospect of recession does loom, with all that means for bad debts and a weakening in financial strength of many institutions.

And there is danger of contagion – if a big debtor does collapse or reschedule, others may be tarred with the same brush. This could provide painfully exciting times, and I am sure that foreign financial predators will now be getting ready to scavenge.

To sum up, these possibilities all add significantly to the risks facing financial institutions in the 1990s. The world is littered with examples of problems that have followed the build-up of external debt. Financial institutions operating in Australia should be aware of this. □