

Beyond the Australian Debt Dreamtime: Recognising Imbalances

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Abstract: Sadly, all the efforts of a generation of Australian men and women have only made them more indebted to the rest of the world. Australia's external net wealth is negative, soon passing *minus* \$900b on an accelerating downward trajectory. This ongoing dissipation of national resources is unsustainable. Australians live in a debt dreamtime, one from which the rest of the world has been rudely awakened. After years of inadequate policies, the nation has a large external debt and significant government exposures. Servicing pressures are growing as rising uncertainties permeate global credit markets. Reserve Bank policies are worsening Australia's external position and needlessly driving up internal costs. Major policy rethinking is warranted. Relevant issues are still little considered, crowded out of dialogues by comforting myths that accompany the Australian Debt Dreamtime. Imbalances need proper recognition with new approaches and strategies developed. Automatic corrections will not occur as history and current overseas experiences demonstrate. A real awakening, improved positioning and a touch of luck are required if Australians are to avoid being seriously impoverished by world events and their own confused Dreaming.

I. INTRODUCTION

The goal in this paper is to explore several worsening imbalances that threaten Australian prosperity. Rising problems have gone addressed because current preferences ignore them. Australians and their policy makers need to wake from their economic and financial dreams before they stumble into an economic crisis.

1.1 A new Dreamtime?

The Dreamtime is an ever-present time of Dreaming wherein Aboriginal people in Australia believe the world and its creatures were created and are renewed. The many sacred tales were

passed on by word of mouth to those deemed able to act responsibly¹. Today, some are read as tales for children.

‘One day a bat named Kunbul was sitting alone by his fire in the bush. Two flying foxes saw his smoke and decided to join him... When Warlet and Ninji sat down, Kunbul thought they smelt bad ... [and] sneezed “You fellas don’t smell right to me.” ...’

‘Warlet and Ninji were shocked by Kunbul’s bad manners. They thought everyone smelt the same, you see. They didn’t like being told that they were different. So they decided to tell their father, old Kul-man-gut the Rainbow Serpent. ...’ (Cowan 2000)

The Rainbow Serpent agrees Kunbul is to be “taught a lesson’ and he intervenes in ensuing battles, with consequences for both sides. Both sides find their liberties constrained, the bats being made to inhabit dark caves and the flying foxes the marshes. None are to fly in the light of day.

The Debt Dreamtime is more modern. This Dreaming offered a common creation myth of innovative finance and efficient markets creating a prosperous world. Sophisticated tales of many types were passed on widely and indiscriminately. “This time is different” (Reinhart and Rogoff 2009) was the cry used to quieten the skeptic, a cry used many times historically in the prelude to crises.

Many acted incautiously. Indeed, whole tribes, companies and nations adventurously embraced investments devoid of familiar features or safe recourse. Reports from the markets were exciting, and overblown. Risks remained unappreciated. In the Debt Dreaming of Australians, many considered themselves good investors yet two-thirds did not consider risk and return (anon citing Australian Government Financial Literacy Foundation 2007).

When a modern Kunbul ventured “*You fellas don’t smell right to me*”, the flying foxes reacted with opprobrium and again enlisted supernatural aid. Select “economic” papers and opinions hurled by high flying foxes now replaced the spears that rained down in previous Dreamings to teach Kunbul a lesson.

It takes a powerful creation myth to alter the views of a generation. Modern myths of markets and globalization are powerful, and those who question such myths need to provide not just facts but a more appealing myth if proper resolutions are to be achieved. Such are the challenges in moving beyond the current Debt Dreamtime and the world so created.

Empirical and schematic analysis is used to outline some key external and internal stresses. These are exacerbated by current policies. The positions of Australia will only be improved by refreshed thinking, more sensitive policies and apt interventions. Whether crises might eventuate is an open and real issue.

The influence of high interest rates is particularly important, and destructive in several areas. Monetary policies focused on inflation that *indiscriminately* set a high price for money needed to be discarded in the move from a closed to an open economy. They were not, and the burgeoning carry trade in currencies is but one result. Policies more attuned to the possibilities of an open economy were needed last century, before imbalances grew so pronounced.

¹ The tale used allegorically here was related by Kianoo Tjeemaree of the Murrinpatha people in today’s Northern Territory (Robinson 1968). Like Aesop’s fables and like moral tales it involves animal characters with human traits. A bat and two flying foxes cannot resolve a lack of understanding themselves so it becomes a dispute to be settled by their common father and creation spirit. This serpent of many hues is powerful and often unpredictable.

The broader issue is one of allocation. Misallocations of funds are now manifest in a heavily encumbered economy and in major external liabilities. These will not be rectified by even the most bountiful minerals boom. It was foolish to put “all the national eggs” in one ore basket. Current exposures set a precursor to crisis, with triggers already setting. Options from outside the current mind set need to be adopted to defuse current threats. A crisis does not arise without some serious misspecifications being commonly incorporated into thinking and policies. Misspecifications and imbalances inherent in the Australian Debt Dreamtime need to be redressed, now.

A paper such as this can only offer some explorations of what is a very complex area. The scope is wide in an effort to show little-appreciated interconnections and to stimulate dialogues and actions. Some depth is necessarily sacrificed, as it will be in any such sketch, but we cannot sit idly waiting for a full resurvey of the area. Continuing uncritically with ideas, methods and understandings that have been part of the genesis of serious exposures is not a sensible option. Windows of opportunity still remain but they are closing, quickly now given EU events. Rectifications will only become more difficult as crises deepen elsewhere.

How Australia’s external imbalances are worsening and stresses rising are discussed in empirical and conceptual analysis of the international accounts in Section II. The roles of interest rates and key limitations on Australian monetary policies are the focus of Section III. Monetary policies are delivering perverse outcomes, including for Australian governments (Section IV). Servicing rising common obligations held as debt and bonds will be increasingly difficult unless external rebalancing and monetary rectifications occur.

II. IMBALANCES AND STRESS

2.1 What the Numbers Reveal

If Kunbul were to visit Australia today he may well be perplexed by what he observes in “the lucky country”. Different tribes wander the land proclaiming how good things are, yet insights gleaned from his vantage suggest that things are very different, or may be so soon. The statistics for Australia do reveal, amongst other things, that:

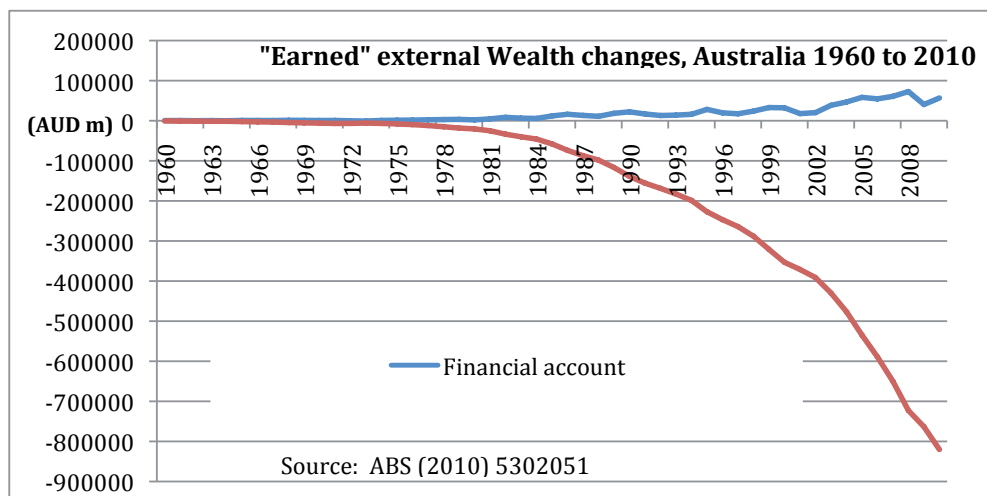
- expenditures exceed product which exceeds income
- debts which fund the gaps are growing apace
- a sizeable source of funding lies beyond Australian shores
- real interest rates and the interest burden on households are historically very high
- infrastructure funding conditions are the most adverse they have been since the Federation began
- even some banks are finding funding most difficult.

Kunbul holds a simple ethos: *if you take more than you give you will need to change something sometime, else you risk everything*. Maintaining due balances was always important in the harsh Australian clime. When he told the flying foxes *who arrived uninvited* into his camp that they didn’t “smell right”, it had been the truth. His motivation seems sourced in concern for their well being. Yet they took affront and went off to that treacherous serpent who ultimately banished *them all* from the light of day.

Today things seem different, but are they? Across the lands many imbalances are evident. How do those in Australia continue to spend more of their sacred “monies” than they earn, still obtain credit and attract ever more monies from over the seas? To Kunbul, this just does not “smell right”. Still a whole generation seems to have lived this way, in a Dreaming that simple bats struggle to understand.

The net external wealth of Australia has deteriorated across the generation (McGovern 2010b, from which *Figure 1* is drawn). Calculation of external wealth is based upon cumulative financial surpluses from an essentially zero basis in 1960. As is evident, Australia has been increasingly building external liabilities. A particularly marked decline has occurred over the last decade resulting in a total external exposure of \$820b as at June 2010 with an annual deterioration of over \$50b.

Figure 1: “Earned” External Wealth Changes, Australia 1960 to 2010



Such calculations are naïve in that they do not allow for revisions due to the cumulative effects of exchange rate influences, investment performances, asset or liability writedowns and the like. McGovern (2010a, *Table 2*) using Reserve Bank of Australia (2010) notes total Australian net foreign liabilities of \$764b which is mainly net debt of \$672b held principally by financial corporations (\$405b or 53% of liabilities) and non-financial corporations (\$159b or 21%) as well as an unitemised external debt liability of \$109b (14%). Net equity liabilities were \$92b (12%).

Comparing the two aggregates shows only a \$56b difference, a relatively slight variation (7%) given recent circumstances including foreign exchange movements. Current strategies are not working. So far at least, Australian funds going overseas have not notably outperformed those staying in Australia. Inward investments and related exports are not rectifying the *Australian* situation. Further research is warranted into the relative returns from investments made in Australia and externally as well as their risk profiles.

The central conclusion is stark: *all the efforts of a generation of Australian men and women have only made them more obligated to the rest of the world.* All that reform, all those industry and government initiatives, all those strategies, all that talk of productivity, all the promises

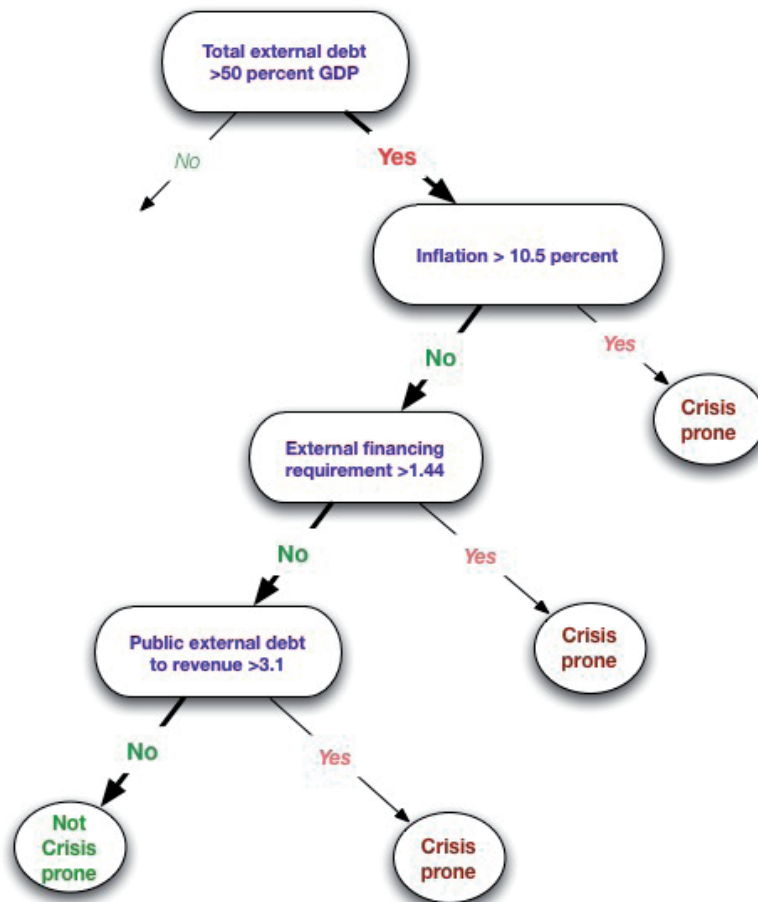
of a previous boom in mining – all have come to naught. Today, we stride the world stage with external debts and other net liabilities above seventy percent of GDP, and increasing. Unaddressed, this is a precursor for crisis as is next discussed. How this situation might have come about is then considered. Finally the (growing) obligations of governments are detailed.

2.2 *Incipient Crisis or Ongoing Dissipation?*

The declining external wealth of Australia reflects high and rising external liabilities of various types. The ability to meet such liabilities becomes increasingly doubtful as they rise in value as a proportion of GDP. However, size alone is an inadequate guide to prospects.

Manasse and Roubini (2005) empirically explore past crisis experiences to investigate “the set of economic and political conditions that are associated with a likely occurrence of a sovereign debt crisis”. They derive rules of thumb for likely default. Their schema is applied to Australia as shown in *Figure 2. Importantly, Australian external obligations are largely*

Figure 2: “Rules of Thumb” on the Roads to Sovereign Crisis



Source: Adapted from Manasse and Roubini (2005). Note there are alternate paths not here explored.

held privately so *at face value the sovereign* appears little exposed externally. Importantly also, these are held in Australian dollars. However, the sheer bulk of obligations held by banks deemed “too big to fail” in the Australian context, the sizeable Commonwealth, State and local government debts (Section IV), the uncertainties of currency regimes, the indirect sourcing of some monies and the existence of various guarantees and understandings drive *de facto* and potential *de jure* exposures.

It is just this *uncertainty* about “*who bears which risks*” and “*who guarantees whom*” that has made resolution of existing crises so difficult, and the escalation of some crises so rapid and devastating. Just ask the Indonesians, Icelanders, Irish and Italians – amongst many. In the long history of defaults, there were 48 sovereign defaults between 1976 and 1989 and 16 more from 1998 to 2002 (Feenstra and Taylor 2011, p. 864) but virtually none between 1950 and 1970. Kunbul is very curious.

From this perspective the Australian *governments* are currently not crisis prone. They do have three vulnerabilities. External financing and public external debt to revenue ratios currently appear well under posited trigger points but this could change rapidly with adverse global conditions, unsupportable interest positions or local bank fund-raising failures. More directly, sovereign crisis risk tops 66 percent if inflation were to revisit the levels of the 1970s. While the Reserve Bank may stand ready with “interest rate management” the world has changed since earlier times. In an open economy raising interest rates may exacerbate current account problems and damage the ability to make due payments (Section III). Importantly, no consideration is given here of currency crises or banking (system) crises. These are areas of risk also, and one can lead to another. While any talk of a triple crisis for Australia is premature, suitable analysis should be part of any strategic policy development. Events in Europe have shown how quickly and broadly crises can build. It was *only two years ago* that the European Commission praised Italy, including its “greater resilience to external shocks”. Now Italy is under administration with no politician in the new cabinet (Squires 2011) as, in PM Monti’s words, this “will remove one ground for disagreement”. How the government *of Italy is for Italy* will be revealed in the days to come. There is much to ponder in current developments, and lessons for Australia.

The essential issue is when will lenders stop lending. The long run borrowing constraint (LRBC) relates how anticipated revenue flows need to cover debt servicing and other obligations. This can be applied to firms, households, governments and nations with forfeiture of some held wealth or default argued when servicing revenues are inadequate *or perceived to be such*. The addition of “risk premiums” can rapidly turn such a perception into a reality. Further discussions must wait for another place.

2.3 The Australian External Imbalances of Payments

Credit is needed if expenditures exceed incomes. Australian expenditures markedly exceed incomes, currently by about \$50b every year. Credit has been sourced, nationally and externally, to maintain such an imbalance in Australia for a generation. Full empirical details are provided in McGovern (2010b).

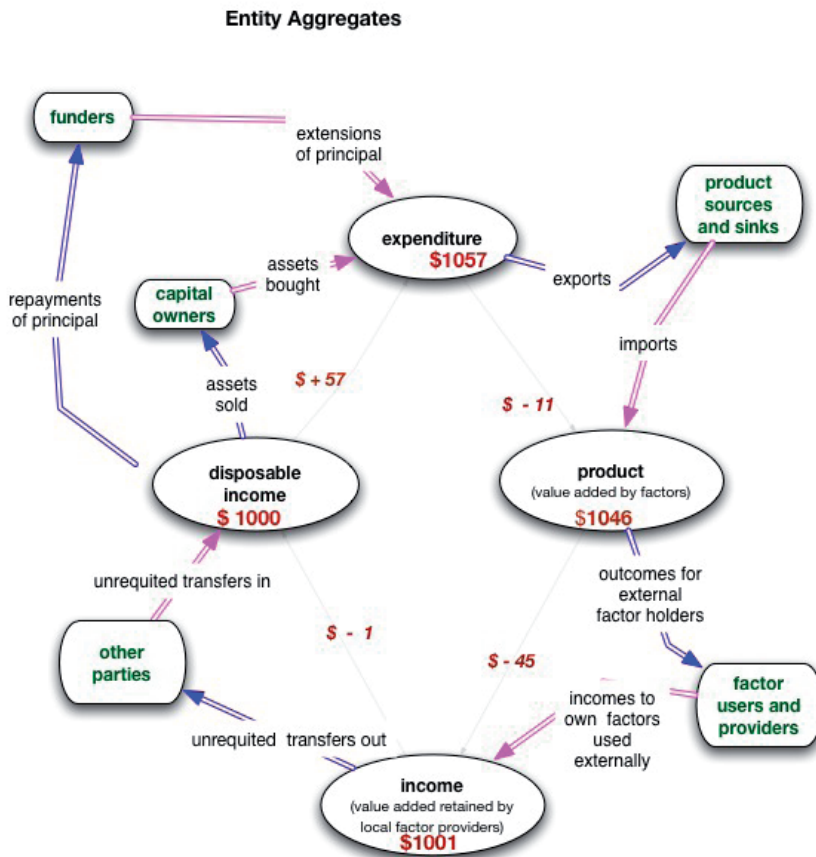
In terms of the national external accounts (ABS 2010; Feenstra and Taylor 2011), the

pattern is built on linking aggregate product, income, disposable income and expenditure. In a closed economy these must, by definition, be equal. This need not be so in an open economy, and Australia has been spending more than its income for years. Specifically, $GNE > GDP > GNDI$. Expenditure exceeds product which exceeds income.

Linkage is via external accounts. Four principal aggregates are linked via five sets of external transactors (*Figure 3*). External balances struck involve *net*:

- **trade**, being product exports less imports;
- **factor income**, being the net current returns to “offshore” factors such as labour (as wages eg), capital (dividends) and monies (interest);
- **unrequited transfers**, being transfers made with no expectation of accountable return;
- **capital items**, being ownership of some (now restricted) capital types; and
- **fund positions**, being both monies and claims allocated via debt and other funding arrangements and (many) ownership claims.

Figure 3: Basic External Account Structure



Australia, Notional 200x (\$A billion)

Sources: Developed from ABS (2010) figures and Feenstra and Taylor (2011).

The first three comprise the Current Account (CA) and represent transactions associated with activities in the year (or quarter) of account. The Current Account links National Expenditures to Disposable Incomes (*via* Domestic Production). The fourth and fifth are a small Capital Account (KA) and a generally larger Financial Account (FA). The growth in the last reflects both the internationalisation of investments and the provision of credits to fund expenditures in excess of disposable income. Kunbul would be sniffing the air.

The focus here is on the key patterns. Figures provided for Australia are for a notional year around 2007, before fluctuations from GFC impacts. They approximate the situation then but require further explications and revisions which will be reported further. Still, the essential situation remains. Conveniently, disposable income at \$1000 billion simplifies percentage calculations, with net factor outflows (including considerable interest payments) above four percent of income and an income shortfall of just under six percent.

Kunbul may well say “You number fellas don’t smell right.” *Around ten percent of current income is now allocated to “just keeping going”* given the divergences between aggregate income and expenditure in the current period and the (accumulated) past. Of course the argument offered by many is that this reflects “past investments” which will pay off. However, the stunning thing about Australian External Wealth (*Figure 1*) is that we have now been waiting for some thirty year for payoffs from hosting visiting funds and investments yet the position is, if anything, deteriorating more rapidly. More tellingly, the most optimistic figures about the current boom do not adequately address Australia’s External Wealth/Obligations problem. Other adjustments will be needed. Serious policy renewal is needed. Dreaming of resurrecting Doha² or of Trans-Pacific Partnerships³ introduces nothing new, and some fundamental changes are now of the essence. While political exaggerations from “delighted” and “excited” Ministers are understandable, the proper response by the governments of Australia is to demonstrate how mooted changes will be good *for* Australia, specifically in rectifying Australian external imbalances.

Put bluntly, Australia’s external position deteriorated as trade liberalisation advanced so any net opportunities that may have been on offer were not realised. *Why should the impacts of any further liberalisations been any different?* When Finance Ministers agree that across APEC “growth and job creation have weakened, inflation remains elevated [and] Capital flow volatility has intensified in response to heightened risk aversion” (APEC 2011), proponents need to demonstrate with convincing evidence *how proposals will reduce risks and rectify problems* in the current environment and going forward. More of the same is not an answer.

Recapping, expenditure can exceed product which can exceed income in an open economy *while credit funds are made available*. The sum of the three external accounts is zero: $CA+KA+FA=0$. For an externally unbalanced economy like Australia, excess expenditures (CA deficit) is balanced by external credits (FA surplus). Aggregate numbers in *Figures 3*

² “Keeping alive the Doha Round, and agreeing innovative ways to deliver on issues such as trade facilitation, will help the world get through current economic uncertainty” said Trade Minister Craig Emerson Swire, M. (2011). Australia Urges Global Rethink Of Doha Agenda. *Tax News*. Hong Kong.

³ “I’ve said consistently to Australians that trade equals jobs,” Ms Gillard said after the TPP meeting. “We are a great trading nation and anything we can do to increase our capacity to trade is good for Australian jobs. ... There is a great deal of ambition and scope in the Trans-Pacific Partnership,” Gartrell, A. (2011). APEC leaders agree on trade deal outline AAP.

and 4 are net. Inflows less Outflows of monies associated with some base transfer (such as product movements) net to the balances shown. So negative balances are net outflows. The balances can be from much larger flows (as in product or merchandise trade where a net \$-11b is associated with exports and imports of over \$230b in each direction), or they may be at around fifty percent of outflows (as with factor incomes). Such details will not be considered further here but balance composition is important when considering potential influences and responses.

As an example, slowing overseas demand and stable domestic demand may see a worsening of the balance of trade even with growth in exports. This could be especially pronounced if overseas producers offer “credit on easy terms” to finance the continuance of exports *from their* production bases by drawing down on their accumulated national surpluses. The extent of price pass through when exchange rates vary is another issue that can lead to significant asymmetries in responses in constituent flows to changing conditions. Adjustments anticipated in theory may not be as quick or simple in practice, especially when significant investments-in-place rely upon continuance of product and associated revenue flows.

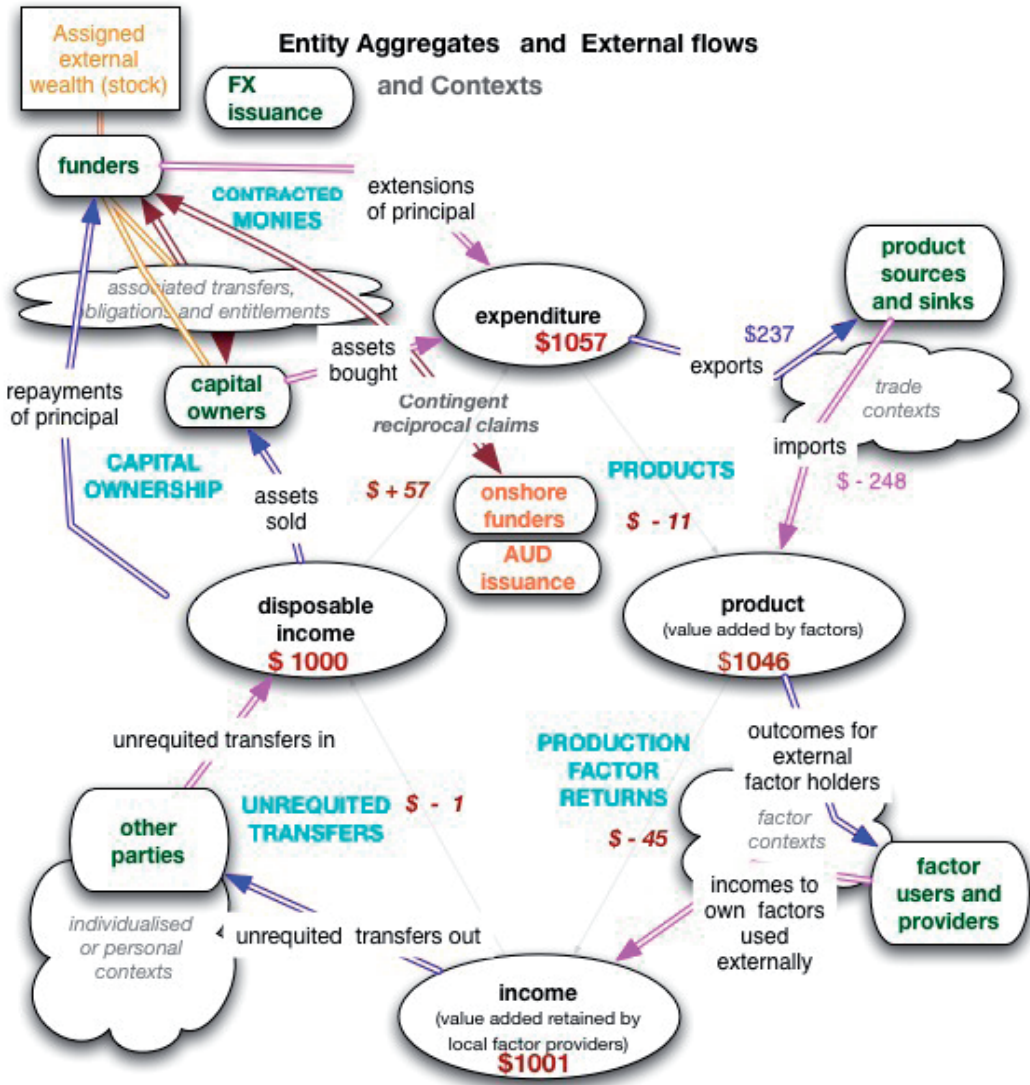
If investments work out “as expected” then obligations are met. If consumption expenditures on credit can be well met by future incomes then the loan is repaid. If not, defaults occur, be they private, corporate, banking, State or sovereign. Australia is a heavily obligated nation facing adverse external economic weather. Australians would be well advised to develop alternate plans in case:

- revenues falter at just the wrong times, particularly those from trade, taxation or labour;
- the general costs of external funding rise, rapidly or slowly;
- a risk premium becomes associated with AUD borrowings, either due to currency instabilities or *a perception* of approaching LRBC issues;
- a capital ‘stop’ occurs with (rollover or new) funds simply not available under global, specific or targeted capital rationing;
- a capital flight occurs (globally or locally) with funds repatriated to home countries or safe havens; or
- some other situation arises that causes an urgent need to rectify Australian external imbalances.

Lenders who wish to be paid “in a hurry” can exact harsh terms. It would also be needlessly tragic if, in a scramble, debts were refinanced in US dollars terms to take account of a short-lived interest rate differential or liquidity option which was then followed by a marked depreciation of the Australian Dollar.

Introduced in *Figure 4* is an elaboration of the gap between income and expenditure as well as some considerations of both contexts and interaction areas. Not only are more possibilities now evident, the existence of alternative pathways allows alternative strategies for bridging the gap between income and expenditure. *It was in just this area that much innovative finance, speculative dreaming, ineffective regulation and “weird” accounting occurred.* The Global Financial Crisis, amongst others, is rooted here. Kunbul was right? While much can be said in this area we will simply note linkages can be many and varied, specifically those involving interest rates in their various roles.

Figure 4: Entity Aggregates and External Flows



Australia, Notional 200x (\$A billion)

FIVE TYPES OF EXTERNAL INTERACTIONS

Notes:

1. National output or "gross turnover" would be about \$2500 as a result of multiple accounting for cascaded product reporting.
2. Exports and imports are values of product output exported and imported so any ratios would exaggerate the relative size of these components (particularly for more highly transformed products and assemblages). The explicit effect on entity cash flow will often be greater than that on value added.

III. INTEREST, GROWTH AND BALANCES

Interest rates can affect investment, growth rates, disposable incomes, foreign exchange rates and economic circumstances more generally. High household debt sees Australians currently paying around ten per cent of disposable income to cover the interest payments needed at current high rates. At the same time, the Federal government seeks to stimulate a potentially stumbling economy while States stimulate with expensive infrastructure. Kunbul hangs bemused. No one seems to question why such high real interest rates remain deliberate policy.

3.1 When Interest Rates are High, and Exceed Growth Rates

Australians have been paying historically high real interest rates for some decades now. The interest-only component of a 30-year loan has been steadily rising, from zero in real terms for loans terminating around 1980 to five-and-a-half percent for those terminating today (McGovern 2010a). Meanwhile, real growth rates in Australia and around the world have been declining.

Such a divergence in trends between interest rate and growth rates is hostile to investment. Not only is there a lower level of overall investment required at a lower rate than at a higher one, the returns on investment actually made need to be notably above the growth rate. A five percent real interest rate in an economy growing at three percent sees investors with the “average” real economy return falling behind by two percent each year. Redistributions occur. Investments that return at the real economic growth rate simply do not “keep up”. Inflation may add distortions but it does not change the “real” underlying, downwards driver.

In considering indicators of fiscal sustainability, Flassbeck and Panizza (2008) state a “common rule of thumb” as:

$$\Delta d = (r - g) d - ps, \text{ where}$$

d is the debt to GDP ratio

r is the steady state real interest rate

g is the long run growth rate of real GDP

ps is the primary surplus to GDP

While this is developed in the context of the public sector, it appears more generally applicable.

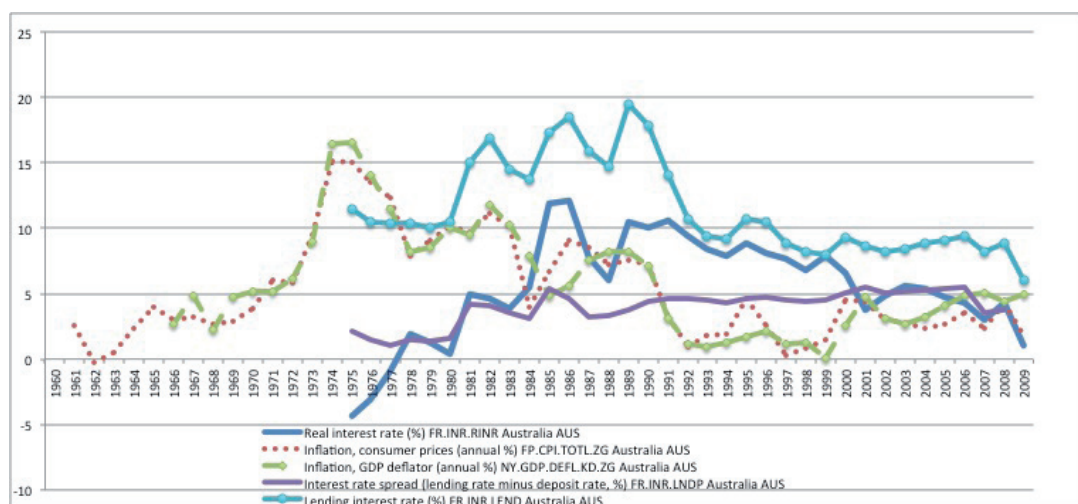
Applied naively to the Australian net external position (by setting $r=0.05$ and $g=0.03$) we find an annual change in debt to GDP of around two percent of the opening ratio less any primary surplus. So in the absence of any current account surplus, debt to GDP would be rising each year by in excess of 1.5 percent ($d=0.70$ times $r-g =0.2$). This is on the existing debt, reflecting a failure to service it adequately. We also need to add on increases in principal as Australia borrows around five percent of GDP to maintain expenditures. Kunbul doubts the “sustainability” of the current position, but he is just a bat using some simple calculations (that are more usually applied in the developing country context).

Arguably, in recent decades the reliance on interest rate movements in inflation targeting along with an insensitive allocation of rates across investment classes have compounded problems and raised investment risk while doing little for inflation objectives. Clearly this challenges current conventions in Australia, and elsewhere, but an argument needs to be had. Reserve

Bank of Australia decisions of interest rates may be well be worsening not only Australian competitiveness (since investment becomes markedly more expensive and unattractive as next discussed) but also its external position (as then discussed).

The historical experience, including as reflected in *Figure 5*, offers at best mixed support to those arguing that interest rates effectively influence inflation. Further, the interest rate spread rose to over four percent in the early 1980s and remained around five percent until the initial onset of the Global Financial Crisis. A similar spread now was then largely restored before contracting recently. Such spreads need to be fully explained and markedly reduced.

Figure 5: Interest Rates and Inflation, Australia 1960 to 2010



High Australian interest rates also impact on Australia via the carry trade. While the potential profits from this are recognised (making even the textbooks, Feenstra and Taylor 2008), the impacts on domestic monies are less appreciated. Monies that flow into a nation’s currency pool may well be utilised within the nation by eager lenders sitting on these substantial deposits. We simply need to “join some boxes” in the top left of *Figure 4* and there is a marked and little monitored (let alone regulated) increase in the quantity of money in circulation. It is then but a short step to an asset bubble, particularly in investments such as housing which are deemed “prime” by distant institutions.

Kunbul reads often that there is no housing bubble in his homeland but he has long wondered how even the Rainbow Serpent could recover the funds on issue. From a different empirical perspective, sovereign yield curves show Australia paying an interest rate at least 1.5 percent higher than key developed nations for longer terms and around 3 percent higher at the shorter end (Australian Office of Financial Management 2010b). How does Australia afford *or warrant* such an imbalance?

3.2 Investment – in Production and Portfolio Cycles

It is at this point that, following Minsky (2008 /1975, 92-104), we may link to the distinction by Keynes between:

- a “prospective yield on investment” in production regarded as a series of annuities Q_i ($i=1..n$) arising from the physical output produced (within a cyclical framework with varyingly scarce Capital allowing quasi-rents), and
- those returns q_i ($i=1..n$) from a portfolio of financial assets with the real interest rate playing a pivotal role.

Real investment requires investor preference for the Q_i over the q_i . Decisions will be cast within some evaluative framework where various estimates and attributions are made to give some comfort or confidence about a decision for which at least some of the consequences remain inherently unknowable.

From a complementary perspective, consider the debt funding of investments that have a delayed cash flow. Infrastructure investments such as the building of a dam “suffer” from such a timing mismatch. Costs “up front” are supposed to be serviced from “later” returns. In the case of a dam, for example, essentially all costs must be met up front yet full utilisation and a strong revenue stream may take half a century or more. Infrastructure investments in particular highlight a long-lived life cycle for the production-base established by the investment.

Three cycles that can then be discerned are those of the:

- quasi-rents, where the actions of competing investors matter;
- financial portfolio mix, where the interest rate particularly matters;
- production base established, where the design specifics matter.

All will have historical presences. All such cycles historically provide relatively good and bad times to act and invest.

Illustrative calculations using historical real interest rates for Australia since Federation in 1901 show very different payments to the lender and returns to the borrower for a 30 year loan on the same illustrative revenue stream (McGovern 2011). Indeed, the experience for 1980 investments terminating in 2010 was the most adverse of any since Federation, closely matching that running 1925 to 1955 but markedly inferior to those commencing in most other years including 1970.

The simple lesson is that conditions can change drastically in the space of a decade with a previously very attractive investment returning very poorly if initiated ten years later. The further lesson is that a variable interest rate environment imposes largely unmanageable risks on long-term investments and can make the prospective yield on a real investment even more uncertain.

Links back to the external accounts can appear from the relatively unattractive investment climate in Australia that has been sketched. A link that appears unappreciated is that *high domestic interest rates may compound current account problems*. The argument is next explored, from two main directions.

3.3 Inflation Targeting in an Open Economy

The largely unquestioned use of variations in interest rates as a policy tool is now questioned. It has always struck Kunbul as peculiar that long-term agreements between two parties could be set in so many ways but costs imposed on one party could be allowed to fluctuate according to the short-term needs of a second and third party. But Kunbul is but a bat.

Four of the lines of challenge involve:

- logic and design issues,
- institutional arrangements,
- effects on project risks and capital accumulation,
- effects in the national external accounts.

Only the fourth is addressed here. The essential question is “could high interest rates exacerbate external exposures?” The answer is “Yes”. This can be demonstrated through modeling and more theoretical considerations.

“in standard open macro models with incomplete information, monetary policy geared towards price stability may result in (rather than correcting) misalignments in important asset prices like the exchange rate, even when the latter only reflects fundamental-based valuation. . . . A comparatively small number of contributions have looked at the implications for monetary policy of misalignments that arise from the dual role of the exchange rate in goods and asset markets.” (Corsetti, Dedola *et al.* 2009)

That is, monetary policy may misalign exchange rates further and few macro-analysts consider asset market implications of monetary policy.

While the modeling reported is preliminary it has significant implications. The study recognizes *that monetary policy effects vary* depending on relatively high or relatively low trade [price] elasticity and whether export prices are sticky in the source (PCP) or destination (LCP) nation, as summarized in *Table 1*. In evaluating monetary policy it is then not just an issue of generic “openness” but of trade elasticities and where price stickiness occurs. Kunbul wonders which box Australia is in, and where its central bank thinks it is.

Table 1: Allocation Impact of “Optimal” Monetary Policy under Cooperation

<i>Under optimal monetary policy</i>	Export pricing stickiness		Trade-off
	in origin	in destination	
trade elasticity	PCP (producer country pricing)	LCP (local currency pricing)	
relatively high price stability (PS) goal	<i>allocation is close to that for... domestic production price stability</i>	<i>allocation is close to that for... domestic CPI stability</i>	<i>PS brought about at the cost of not redressing exchange rate misalignment, but limited consumption and employment impacts</i>
relatively low price stability (PS) goal	misalignments are sizeable (and of wrong sign) with large deviations from optimality domestically and across countries		<i>perverse trade flows and large consumption and employment impacts</i>
relatively low Ramsay policy goal	improvement over PS	significant improvement over PS	<i>better external orientation at the cost of domestic price stability</i>

The key point is that seeking price stability through “optimal” monetary policy may result in significant misalignments and perverse impacts. It may be better to “lean against the currency” rather than “raise interest rates”. The practical distinction between currency “leaning” and “management” is unclear so while there may appear to be an alternative its viability may be practically limited and speculative.

It is important to recognize that “optimal” is here defined in terms of current (global) markets *and not in terms of national external imbalances*. So even a more sensitive, broader monetary approach may not improve the external position of Australia or others with large external liabilities.

A more telling analysis is offered in Arize, Bonitis et al. (2000) who explicitly address alternative theoretical frameworks used to consider balance of payments adjustments.

”The monetary theory does contain some elements of truth which the Absorption [Traditional or Keynesian] theory bypasses (and vice versa). ... The basic question concerns the value of the two theories in explaining the elimination of a deficit.” (Gray 2000)

Gray finds both deficient but each may be potentially useful. Portfolio balances provides an alternative focus. Each approach strikes a different stance and focus.

The monetarists “look upon the current account, the capital account and the official reserve transactions as the main components of the balance of payments” while the Keynesians focus on goods and services. (Johnson, Kasibhatla et al. 2000).

“An important major shortcoming of the Traditional approach is that it only discusses, in its attempt to explain external disequilibria, intermediate parameters such as relative incomes, prices and interest rates, and not the causal root parameters... [it] looks at the vehicles of transmission of disturbances, not their causal parameters.” (Bonitis and Malindretus 2000)

Of immediate interest in terms of interest rate effects is that the Traditional approach sees a raising of interest rates as curbing external current account deficits while the Monetary approach sees the opposite. Thus “traditionalists” see Australia’s external problems as being improved by raising interest rates while “monetarists” see them as being worsened.

The possibility that actions by the Reserve Bank in Australia may be worsening the external situation in a variety of ways needs to be investigated further. This brief commentary has highlighted some of the lines of investigation that appear relevant. A country may be facing a disequilibrium for a variety of reasons and there appear to be no compelling *a priori* or empirical reasons to expect these to self correct. Clearly, policies in this area need thorough review and justification as to adequacy and effectiveness in the circumstances that Australia with its unbalanced accounts faces. Continuing policies that have accompanied an ever-worsening external situation is not a sensible option.

IV. THE SITUATIONS OF AUSTRALIAN GOVERNMENTS

4.1 Empirical Financial Situation of the States and Commonwealth

It is fascinating that Government financial situations were not assessed in either Henry (2010) or in the lead up to the Tax Forum (Commonwealth Treasury 2011). Instead the focus has essentially settled on who to tax more, and the purported efficiencies of different ways to do it.

Why there is a need for governments to raise more tax goes unaddressed, as do other relevant considerations. Such myopia appears to be risky and, probably, dangerous.

The assets and liabilities of the Australian governments are shown in Table 2. Numbers are drawn from the various statements of each of the States and the Commonwealth as at June 30th 2010 (Australian Office of Financial Management 2010a; Northern Territory Treasury Corporation 2010; NSW Treasury Corporation 2010; Queensland Treasury Corporation 2010; South Australia Treasury 2010; Tasmania Department of Treasury and Finance 2010; Western Australian Treasury Corporation 2010; Treasury Corporation of Victoria 2011). Differences in reporting practices lie behind the unevenly reported *italicized* sections and Notes which should be regarded as subject to revision, including as regards “unclear” superannuation exposures (Mayne 2010, Kohler 2011).

Table 2: Assets and Liabilities of the Australian Governments

2010 (\$b)	Commonwealth of	State of							Aggregate
	Australia	Queensland	New South Wales	Victoria	Western Australia	South Australia	Tasmania	Northern Territory	
Assets									
Onlending	2.7	55.1	44.6	21.8	22.0	9.5		2.9	158.6
Other financial	30.7	18.7	12.8	10.0	3.5	16.7	5.0		97.4
Subtotal	33.4	73.8	57.4	31.8	25.5	26.2	5.0	2.9	256.0
Other									
Long term financial	..	19.2	..	..	..	..	..	..	..
Non financial	..	..	..	..	..	55.7	21.3	..	..
TOTAL	33.4	93.6	57.4	31.8	25.6	80.0	26.4	2.9	351.1
Liabilities									
Bonds	130.2	68.9	43.5	23.9	25.2	5.3	4.4	2.9	304.3
Bonds indexed	16.2								16.2
Notes	10.9					6.6			17.5
Other		4.7	13.8	5.7		15.4			39.6
Subtotal	157.3	73.6	57.3	29.6	25.2	27.3	4.4	2.9	377.6
Other									
Long term financial		23.3				17.1	5.5		45.9
TOTAL	157.4	97.1	57.3	31.6	25.5	44.4	13.3		426.6
NOTE: Bonds guaranteed by Commonwealth (Aug 2010)									
	151.5	42.0	22.0						
(June 2011)									
	191.3	21.8	17.9						
Net assets									
from Subtotals	-123.9	0.2	0.1	2.2	0.3	-1.1	0.6	0.0	-121.6
TOTAL from All reported	-124.0	-3.5	0.1	0.2	0.1	35.6	13.1	2.9	-75.5
NOTE:									
Annual interest									
Interest income onlending		4.0	2.4	1.0	0.9	0.6			8.9
Interest income invest/other	1.3	1.0	0.5	0.4	0.1		0.1	0.2	3.6
Interest expense	6.3	5.1	2.7	1.4	1.0	0.8	0.2	0.1	17.6
Net interest	-5.0	-0.1	0.2	0.0	0.0	-0.2	-0.1	0.1	-5.1
NOTE:									
Unfunded superannuation liabilities	> 50	..	-0.2	..	..	8.9	3.5	..	> 60
Sources									
	AOFM 2010	QTC 2010	TCORP 2010	TCV 2010	WATC 2010	SAT 2010	TTAFR 2010	NTTC 2010	

The Commonwealth has a stated net exposure of \$124b as at June 30 2010 (with an additional \$67b in liabilities taken on in the following year). The States generally appear close to financial balance. However, those States using Treasury Corporation are on-lending to their various agencies with high interest repayments expected in return. Rising utility service prices, for example, appear influenced by high bond servicing costs, an issue not commonly recognized. Inflationary effects result.

Again these figures need further elaboration but observations include:

- the singularly high net exposure of the Commonwealth;
- that bonds and notes totaled around \$340b or over 25 percent of current GDP across all governments with an annual interest expense of \$17.6b;
- that the *net* exposure (Assets less Liabilities) is around 10 percent of GDP;
- that the liquidity of underlying Assets is unclear, as is the appropriateness of booked valuations;
- the stated interest repayments for Queensland and NSW are particularly high (with deducible interest rates of 6.9 and 5.3 percent respectively) compared to Victoria (around 4.7 percent) and the Commonwealth (4.0 percent);
- Queensland has assets (and liabilities) valued markedly more than those of New South Wales and Victoria;
- that more adequate, consistent and complete reports are needed.

There is no obvious discussion of reducing borrowings in the various reports. Indeed, Queensland which is not projecting a surplus (of \$0.1b) across the general government sector until 2015-16 increased its debt by \$4.2b in the last year. It is planning to continue capital investments of over \$10b annually for some years (Queensland Treasury Corporation 2011a). Why State debt more than doubled in four years, from \$32.1b in 2006-07 to \$73.1b in 2010-11, despite around \$15b from asset sales (*ibid*) is an unexplained mystery⁴, as is the lack of discussion of such a significant increase in exposure while global conditions were deteriorating markedly.

So, Queensland “is different” but

“Queensland has a long history of setting aside funds to accumulate financial assets sufficient to meet future liabilities, the largest being for future employee entitlements, in particular superannuation. Queensland is therefore far better placed than other state governments to meet future accruing liabilities, as most other jurisdictions have substantial unfunded superannuation and other employee liabilities” (Queensland Treasury Corporation 2011b:S 76)

So what is the real financial health of the States and Commonwealth? It is worth recalling that Treasury Corporations are charged with arranging funding for decisions made “elsewhere” while Auditors General have adopted relatively narrow audit perspectives. It is unclear which agencies, if any, are tasked with reviewing “financial health” and the sustainability of current arrangements. There is a clear governance issue here, one neglected by existing agencies and in all the talk of tax reform. It seems appropriate that the States and Commonwealth explain

⁴ Queensland is expecting to have recent natural disaster costs for the public sector of over \$6b over several years three-quarters met by the Commonwealth, leaving an exposure of around \$1.7b for Queensland. These and the timings of some receipts may provide a small part of the story, but they are inadequate explanation of debts more than doubling.

their positions more fully, lest investors become concerned. Which of the challenges raised by Moody's in 2009 have been adequately addressed, in Queensland and elsewhere?

“The [Queensland] downgrade reflects the state's deteriorating financial and debt performance and the absence of a medium-term strategy that would over time restore budgetary performance and financial flexibility... the state is expected to produce a series of very large, recurring deficits. The widening budget gaps and the resulting additional borrowing that is being projected place the state on a debt trajectory that is no longer consistent with Aaa debt metrics. Additional budgetary pressures could emerge should economic growth be slower than currently anticipated. Queensland's financial performance is also expected to be challenged by the difficulties in reducing operating spending following a period of accelerated growth.” (Moody's Investor Services 2009).

4.2 On Principles and Practices

A convenient statement of the guiding financial principles adopted by the Australian States can be found in the QTC statement to the US Securities and Exchange Commission as part of the 2011 supplement to its \$20b bond raising (Queensland Treasury Corporation 2011b). Since 1992, balance has been sought between assets and liabilities by the Australian States (rather than debt repayment).

The major feature of the new Loan Council arrangements is the switch in focus from gross borrowings to an aggregate based on net borrowings as indicated by a jurisdiction's deficit/surplus. The rationale for the switch in focus from global limits to an aggregate based on the deficit/surplus as a measure of the financing requirement is that the Global Approach focused on gross new borrowings by jurisdictions rather than their net call on financial markets; the latter is a more meaningful indicator of the impact of the public sector on the economy (Queensland Treasury Corporation 2011b:S 71).

But what of the impact of public sector debts on taxes and charges or of the needs for repayments?

The appeal of such an approach to entities that hold the unalienated lands of Australia and most of its public physical capital but are revenue constrained is obvious. This position of the States contrasts with that of the Commonwealth which holds few physical assets but controls large revenue flows and the currency. The latter is a Sovereign with few physical assets. Such things make the Australian situation different from that in many other nations. There are policy options in Australia that are not generally available, but this is a matter for another paper.

Of late, State liability undertakings have been principally constrained by the value of assets “on the books” rather than by any repayment revenue stream. Indeed the ability to repay a loan has become secondary across much of the economy so the States should not be unduly criticized for adopting the practice of rolling over loans that became increasingly common up until 2007.

Such a strategy involves refinance risk (Wild pers comm and as acknowledged in Queensland Treasury Corporation 2011b): that the “new” funds will not be available at all or will be available only at a higher interest rate than anticipated. In the modern economy, the former requires a non-diminishing pool of funds while the latter reflects competition for a relatively limited pool of funds. As is now appreciated by many, the global pool of available funds has diminished since 2007, despite attempts by various central agencies in different nations to restore its size.

Unless it can acquire or build (considerable) assets, the Commonwealth and its agencies need to pay more attention to fiscal balances and debt servicing in the current period. A Commonwealth “takeover” of a hospital or education system, for example, would have major implications for the balance sheets of the States while potentially allowing some balance sheet latitude for the Commonwealth. Seen in this light, calls for the reform of education and health, amongst others, may be more about (physical) recapitalization of the Commonwealth after years of asset sales from which sadly few returns remain. Local government amalgamations and corporatisations offered similar prospects for the States, particular when LGAs which had been operating to manage gross debt exposures offered “untapped” assets usable to counter increasing liabilities. Clearly such comments are speculative but they do reflect a certain logic.

It is clear that not only are liabilities, specifically debts, high. In terms of the presented accounts, assets appear to reasonably match liabilities *given* current valuations. *If so*, any anticipated problems would be ones of liquidity rather than solvency. That is, the central problem is one of achieving appropriate flows of revenues and payments while maintaining (or perhaps improving upon) the stock situation.

If however, assets were not realizable at the stated values then solvency problems can arise. As evident in Europe, one response is partial or full default on obligations. Through unilateral or agreed actions, liabilities are written down to the full or partial cost of other “funding” parties. The now less-encumbered party ideally reduces own-liabilities to a “now-serviceable” level while also seeking to retain revenues sufficient for essential services. Default crises can engender banking crises, or they might prefer a currency crisis?

While sales of assets may be made as part of such processes, problems can be expected if revenues foregone imperil the servicing of remaining obligations. Typically it is markedly easier to sell assets with good revenue streams so sales of such attractive assets may compound problems, as seems to be the case in Queensland and elsewhere. Additionally, contractual arrangements can open unanticipated exposures, as with the NSW Waratah trains and the threat to the State rating (Wade 2011 Oct 19).

It is at this point that we need to return to the wider world and the possibilities arising as crises unfold.

- If interest rates rise (strongly), then liabilities may escalate (markedly) due to the exposures and linkages demonstrated earlier.
- If interest rates fall then liabilities may fall if no refinancing problems arise.
- Given the destruction of the global capital stock already there are issues of sufficient availability “at all” and “under manageable conditions”.
- If a debt-deflation were to occur then the States could be quickly squeezed as asset values fall while liabilities at least remain.
- If inflation were to rise rapidly then monetary policies using rising interest rates could be particularly difficult to manage and potentially stagflationary with worsening external exposures.

We could go on but sufficient has been said to highlight issues and complexities that need proper consideration by those charged with the economic well being of Australia.

V. UP A GUMTREE IN A BUSHFIRE? THE AUSTRALIAN DILEMMA

As the fires feeding on years of lush credit growth rage in many parts of the world, Australia has been so far only a little affected. Significant exposures exist, however, and these need to be assessed and redressed. While no one can know just what blazes will break out next or where, prudence mandates risk assessments, readiness, firebreaks and controlled burns. Recovery is much more expensive after an unanticipated fire, and some losses are never really replaced. As even Kunbul knows, this is not a time to be dreaming up a gum tree.

A wide-ranging exploration has been presented in this paper in an attempt to understand the current “debt dreamtimes” of Australians. The initial focus was on the empirical external situation of Australia, particularly its large and growing net external exposure due to expenditures exceeding income by around five percent of GDP recently. Net external factor servicing costs already account annually for a similar proportion of GDP. Such imbalances already create difficulties and might bring on crisis, though this seems not likely yet.

Current external policies favour a major expansion of mining to lead export growth. However, the current mining sector would need to roughly double its exports for Australia *to stand still externally*. It is not only the trade balance that has to be rectified but also the net factor income outflows. Given that mining is focused in three States that already have high public liabilities, funding further infrastructure becomes even more problematic.

Superficially the Governments of Australia appear in a reasonable position when compared to much of the world. Servicing of obligations appear problematic, however, even under optimistic scenarios. Closer investigations of positions is clearly warranted. This initial review has revealed significant potential vulnerabilities. Adverse conditions externally could lead to a rapid deterioration due to refinancing risks while recession would reduce the ability to raise sufficient net revenues to service existing obligations.

A number of domestic factors were also considered, particularly real interest rates which have been at historically high levels for years. Such interest rate settings can introduce a range of problems with investments, including in infrastructure, and may exacerbate the external problem. High interest rate policies targeting inflation may have perverse and potentially pernicious effects in an open economy. Improved understanding of interplays in the financial account area is needed as a priority.

Current crises can be seen as problems of systemic misallocation, so the framing and decision cycles underlying current allocations need to be considered.

A statement on the current “debt dreamings” of Australians has been presented in terms of:

- *external exposures* of the nation which exceed \$800b largely held in Australian dollars at the time of writing. National expenditures exceed product which exceeds incomes ($E > P > I$).
- *direct exposures* via Governments. This is large and growing, but largely domestic though there is some external liability.
- *indirect exposures* through financial collectives (banks, other financial organisations and the financial system). This is both domestic and external, and potentially significant.

Well-informed dialogues and skilled responses will be needed before current problems are satisfactorily resolved. Australia will indeed be a lucky country if it can achieve this without

crises, major capital losses or austerity. There are ways through (as discussed elsewhere) but actions need to be taken before current windows of opportunity close.

Three areas that particularly need attention are:

- ***Defusing stresses and reducing exposures.*** Currently Australia faces particularly uncertain times while carrying a large external exposure. The way this exposure is held and renewed (much was 90 day debt in late 2010, for example) needs to be carefully investigated and well managed. The national excess of expenditure over income needs to be reversed in an effective, timely manner.
- ***Policy rebalancing.*** Policy assumptions about external flows, the attainment of balances and interest rates need revisiting and reconsideration. Thinking about money, finance and the real economy needs to be reconnected, and broadened. Uncertainty and investment basics need incorporation into more adequate conceptualisations and models of the open economy. More immediately, further raising of real interest rates appears counter productive and might expedite crisis.
- ***A rejuvenated dreaming?*** “We” need to think more adequately about our world and the possibilities we generate. Existing thinking and conventions have led to foundational crises, not superficial ones. At heart is a misallocation problem, with a spurious solution of “more debt” adopted. We need to both reframe our thinking and allow dynamic considerations of the mutual engagements that strengthen societies and economies.

Much needs to be done and properly focussed efforts need to be initiated to restore a proper foundation for national prosperity.

Generational understandings can be rendered obsolete, and potentially destructive, in a perhaps surprisingly short space of time. The turnaround in debt servicing conditions between 1970 and 1980 investments provides but one example. One of the problems this causes is for relevance in both informal education, as in a family, and more formal education. Something learned in 2000 might be obsolete, inaccurate or otherwise inadequate today – even in the absence of crisis. Crisis just makes irrelevance of some particular knowledge or conventional wisdoms that much more likely, and the risks in using it higher.

Appropriate *regrounding* needs to occur both routinely and strategically if apt decisions are to be made. Arguably, this becomes particularly important if policy becomes more founded on management or political perspectives rather than some principled analytics, as occurs in any move from enlightenment to entitlement. Some major changes will be needed if we are to move beyond the mire of the Debt Dreamtime.

In that more ancient Dreamtime, why was the world turned upside down? Why did the Rainbow Serpent intervene? While not understanding the context or the relatively slight nature of the insult, the Serpent did not seek a fuller appreciation, made a cursory judgement based on superficial reasoning, allowed escalation and then imposed his will in ways which seem to this reader as out of all proportion to the original (and subsequent) transactions.

“... all the flying foxes gathered round old Kun-man-gur the Rainbow Serpent to thank him for his help. Kun-man-gur flashed his forked tongue and smiled. ...”

‘This country belongs to us, now that Kunbul and his friends have run away’ said Ninji. But old Kun-man-gur shook his towering head. ...

When they reached the riverbank, old Kun-man-gur cut down a piece of hollow bamboo. This he filled with all the flying foxes, including Warlet and Ninji. ... Then he dragged the piece of bamboo and his fishing net to the bottom of the river.

‘All day you can stay down here with me.’ Kun-man-gur bubbled. ‘When the flowers come out, I will free you so that you can eat them... You may feed all night. But at dawn you must always return to me.’” (Cowan 2000)

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