Submission on

Government Support for Australian Defence Industry Exports

by Leigh Harkness

1 Barriers and impediments to the growth of Defence exports

1.1 Australia's capacity to support its defence exports is being impeded by its support for other industries. Australia has limited resources and the commitments to other industries, particularly to the banking industry, has reduced the resources available to support other industries, including defence exports.

1.2 Related to this, the exchange rate mechanism prevents any benefits of increasing defence exports from reaching the Australian economy, thereby weakening the justification for providing support to defence exports.

1.3 Also, the exchange rate mechanism makes Australian industries uncompetitive, thereby making it difficult for Australian defence exports to compete with similar products from other economies.

1.4 Furthermore, despite Australia's massive mineral wealth, the fiscal deficit pervading Australian Federal and State governments reveals that Australian governments do not have sufficient financial resources to make a significant contribution to support defence exports.

1.5 Solutions to these wider problems need to be addressed as part of the strategy to support Australian Defence Exports and improve Australian National Security.

2 Commitments to other industries

2.1 Australia has made substantial commitments to support Australian industries, and the largest by far is its commitment to support the banking industry. The commitment to the banking industry is so large that it makes it difficult for Australia to support its other industries, such as the defence exports industry.

2.2 To understand the extent of this commitment, it is necessary to consider the most basic principle that has been the foundation of the Australian economy: the principle of reciprocal trade. Reciprocal trade means that the money we earn from selling the products we have produced enables us to buy products of equivalent value. That principle provides the incentive necessary for people to produce and trade. Also, it ensures that an economy cannot buy more than it produces.

2.3 Up until the early 1980's there was a minor exemption granted to this principle. Trading banks were allowed to create additional money to lend. Bank lending is an exemption to the principle of reciprocity because the banks have no money entitling them to buy the products being purchased by the borrower. Therefore, when the borrower borrows money from the bank, the bank does not transfer any legitimate economic right to the products that the borrower purchases. During that period, bank lending tended to be short-term loans for business, such as to buy new stock or equipment.

2.4 Those loans could be justified on a pragmatic basis because national savings were involved. When Australia increased its exports, more money would enter the Australian economy. The banking system would convert the foreign exchange earned into Australian dollars and hold the foreign currency in foreign reserves while the Australian dollars went into circulation. When the Australian dollars were eventually spent on imports, the Australian banks would withdraw the Australian dollars from circulation and draw on the banking system's foreign currency reserves to pay for those imports. Yet, as far as the rest of the world was concerned, while the Australian dollars were circulating around the Australian economy, Australia was saving the foreign currency it had earned.

2.5 It was reasonable to assume that Australian banks could lend more money and thereby utilise those foreign reserve savings to increase investment in Australia. Such lending was a profitable activity for the banks. But it needed to be regulated to ensure that Australian banks had the foreign exchange necessary to honour the monetary system's foreign exchange obligations once the Australian dollar funds originally earned from exports were spent on imports.

2.6 In the late 1970's and early 1980's, the banks lobbied government for a more liberal lending policy. Also, they developed means of lending "off the books" that avoided the official lending regulations. Furthermore, banks downplayed the risk of excessive growth in credit. Given that Australia's current account deficits were greater than official bank lending, banks denied that their lending was the sole cause of the current account deficits. They claimed that the less regulated non-bank finance sector was also responsible for lending that caused the current account deficit. In addition, there was foreign pressure to deregulate the financial system, such as from the IMF. The subsequent deregulation of the financial system was a major commitment by Australia to support its banking industry. It meant that the minor exemption to the principle of reciprocal trade was expanded to become a major exemption.

2.7 As shown in Figure 1, bank lending was solely responsible the current account deficit and lending by the non-bank financial sector was not responsible for the current account deficit. Finance from the non-bank sector was money that had been earned through production. The borrowers of those funds were only spending money that someone else earned, but chose not to spend. The non-bank sector lends money held in banks. They cannot create additional money and cause current account deficits. It was only bank lending that that created money the money depleted foreign reserves. The banks' success at avoiding the lending regulations, as well as the more lax lending environment of that time, enabled them to create the money that financed national expenditure in excess of national production and caused the current account deficits that depleted foreign reserves, leading to currency crisis in 1983.

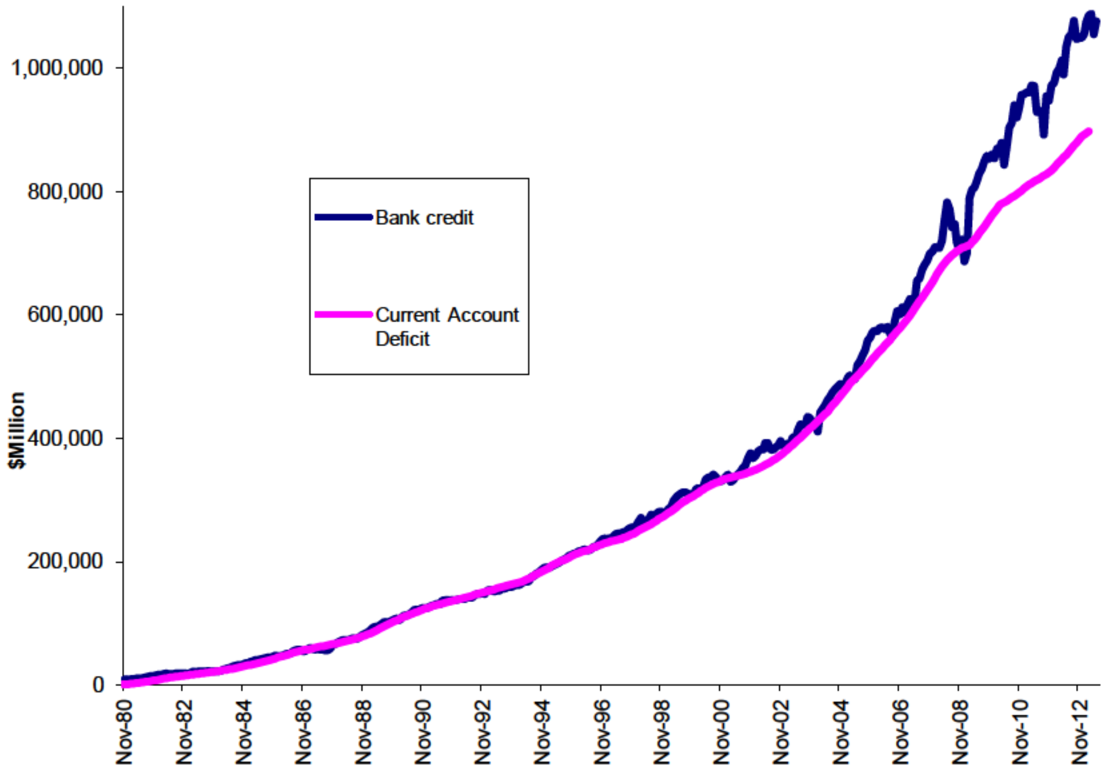

Figure 1. Australia: Bank credit and the current account deficit[1]

2.8 The only way the economy can buy more than it has produced is to import more than it has exported. To pay for its additional imports, Australia had a choice of running down foreign reserves, borrowing offshore or selling off the farm. Initially, foreign reserves were depleted to help pay for the additional imports. However, the rapidly falling reserves destabilised the exchange rate because, if the reserves were to be completely depleted, the banking system would be unable to convert Australian dollars into foreign exchange.

2.9 That threat to the monetary system was defused in December 1983 when the banks were no longer required to exchange Australian dollars for foreign currency. Instead a swap market was established that swapped local currency for foreign currency. This swap market meant that the banks did not have to honour the money they issued by converting it into any other currency. Also, it meant that foreign money never entered the economy and domestic money never left. Another interpretation of this outcome was that it meant that the money entering and leaving the economy was equal.

2.10 Although the decision to establish a swap market for foreign currency was contrary to Treasury advice, it was embraced as a great economic achievement. It was called the "floating exchange rate system" because it required the exchange rate to fluctuate to ensure that the swaps were balanced, or that the money entering and leaving the economy was equal. The government promoted the "float" as a great victory or economic reform establishing a liberal market system for the exchange rate. It was not portrayed as a retreat to position necessary to defend the flawed policy of deregulating bank lending; a policy that undermined the principle of reciprocal trade.

2.11 Floating the exchange rate avoided the need for the banks to hold foreign reserves, but it did not stop bank credit from financing expenditure in excess of production and thereby causing imports to exceed exports. Australia was required to continue to pay for its excess imports. It did so by taking on more foreign debt and selling off capital assets such as Australian real estate and businesses.

[1] Link to data available at: http://www.buoyanteconomies.com/AustCADMoney.htm

2.12 The requirement that international monetary transactions be currency swaps meant that increased exports could no longer inject new money into the Australian economy. Also, it meant that bank credit was now the only source of monetary growth to facilitate economic growth. The international exchange rate system applied to protect the banks meant that there was a prohibition applied to money entering the economy from international trade. The banking system's new monopoly to create additional money proved to be a very profitable bonus for the banks. Their lending was not only beneficial in financing new investments, it was now necessary to facilitate economic growth. However, it also meant that if the economy did not borrow, it would stagnate.

2.13 Given that bank lending no longer depleted foreign reserves, trading bank lending was deregulated even further. Savings banks and building societies, which had relied on savings to finance their lending, could not compete with the banks that could lend by just creating additional money. Therefore, the non-bank financial institutions were converted to trading banks or were amalgamated with existing trading banks. Without the need to distinguish between the savings and trading banks, "trading banks" became known just as "banks".

2.14 With unlimited lending resources, these banks also expanded their lending into new markets such as the home finance market. Bank lending for housing expanded dramatically and drove up the price of houses. Initially, house prices were doubling every few years and the rising house prices increased the demand for bank lending not only from home buyers but from speculators seeking to profit from the rising price of real estate. House prices rose more rapidly than wages so that the cost of servicing a home mortgage grew and exceeded the capacity of most single income families. It became necessary for most families to have two incomes to service a mortgage. Such commitments from families to support the banks raised bank profits even higher.

2.15 The support for the banking industry has allowed the banking sector to grow far more rapidly than the remainder of the economy, as shown in Figure 2. Before 1983, domestic credit provided by the banking sector was stable at around 40 per cent of GDP. Since the float it has grown to exceed 140 per cent of GDP[2]. The fact that bank credit has grown more rapidly than the economy means that the country's debt has been growing more rapidly than its capacity to repay that debt. Such divergences have proved to have catastrophic economic outcomes for the USA and Europe when bank credit exceeded 200 per cent of GDP.

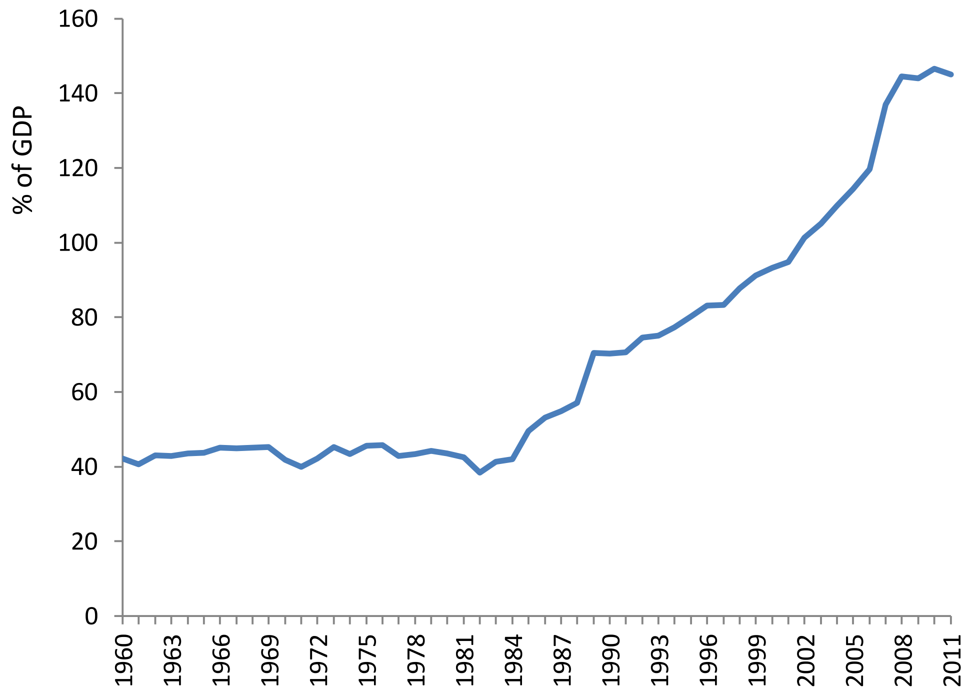

Figure 2. Australia: Domestic Credit provided by the banking sector (% of GDP)

[2] World Bank data available at: http://data.worldbank.org/country/australia .

2.14 It could prove ruinous for the Australian economy, including defence exporters, if the ratio of bank credit to GDP is allowed to continue to grow and exceed the economy's capacity to service its debt. Yet it may prove unfortunate, also, if the ratio does not grow because since 1983, the times when the ratio of debt to GDP has not grown have been times of recession or low economic growth.

2.15 If the current form of support for the banking industry is to continue, then the Australian government is likely to need more resources to support the banking industry when the private sector can no longer afford to service its growing debt burden. This will leave fewer resources to support the defence export industry.

3 Benefits of defence exports

3.1 Before 1983, increases in exports generated additional money and income for the Australian economy. It was during this period that Australia was noted for riding on the sheep's back. During these times, the economy would experience booms when exports increased and could go into recession if exports, or export prices, declined.

3.2 The currency swaps associated with "floating the exchange rate" ensured that the monetary supply was independent of international transactions. In these new circumstances, any growth in exports would not generate any additional income for Australia. Also, this meant that when exports declined, such as during the Asian Crisis, the Australian economy was largely unaffected.

3.3 Under the new arrangements, increased exports may have earned additional income for individual exporters. However, any increase in total export incomes would require a commensurate increase in imports. That is, the economy would be required to shift its spending by an amount equivalent to the increase in exports from domestic products to imports. Therefore, any increase in the income of the exporting industry is offset by an equivalent reduction in the income of import competing industries.

3.4 These changes to the treatment of foreign income make it difficult to justify any support to increase any exports, let alone defence exports. Unless there is a benefit for the whole economy in the form of increased incomes, there would seem to be little benefit from supporting an increase in the incomes of exporters if that support was going to mean a reduction in the income of other industries, particularly import competing industries.

3.5 It is government's support for the banking industry that is undermining the case for providing support for defence exports. Yet, it would appear that the type of support being provided to the banking industry may have outlived its usefulness. Even so, until that form of support is revised, support for the export industry will need to be justified on the basis of non-economic attributes such as the benefits to national security of preserving a defence industry.

4 International competitiveness

4.1 The necessity for government to provide support to defence exporters exists only because the price of Australian defence exports is high compared to the price of products available from other countries. Australia's products are uncompetitive, not because Australians are inefficient, but because the rate of exchange for the Australian dollar is too high. For example, if the Australian dollar were worth fifty or sixty cents US, then Australian defence exports would be much more competitive and would not need additional support.

4.2 The value of the Australian dollar is high because Australia has been a successful exporter. It is the growth in Australian exports that has been increasing the supply of foreign currency on the international currency swap market seeking to be swapped for Australian dollars. Also, Australia's relatively high interest rates is attracting foreign capital which is increasing the supply of foreign currency seeking to be swapped for Australian dollars, thereby inflating the value of the Australian dollar and exacerbating Australia's pricing problem.

4.3 Australia floated its dollar to protect its foreign reserves arising from the excessive growth in bank credit. However, now Australia's problem is reversed. Its exports are growing but the growth in bank credit is not growing sufficiently to increase the supply of Australian dollars on the international currency swap market. If Australia were to return to a fixed exchange rate, its foreign reserves would grow and the Australian economy would prosper from the monetary growth.

4.4 Such an outcome occurred in India early in this millennium. Up until the year 2000, India was like Australia with its current account deficit equal to the growth of bank lending, as shown in Figure 3. Between the year 2000 and 2004, the Reserve Bank of India intervened to stabilise the exchange rate of the Rupee. During that period, the equality between India's currency in circulation (growth of bank credit) and its current account deficit (which had persisted until then) was broken and India experienced current account surpluses. The injection of additional funds into the Indian economy strengthened and stimulated its economy, and the Reserve Bank of India was persuaded that it did not need to intervene any longer in the exchange rate. As a result, India returned to experiencing a current account deficit equal to the growth of its bank credit.

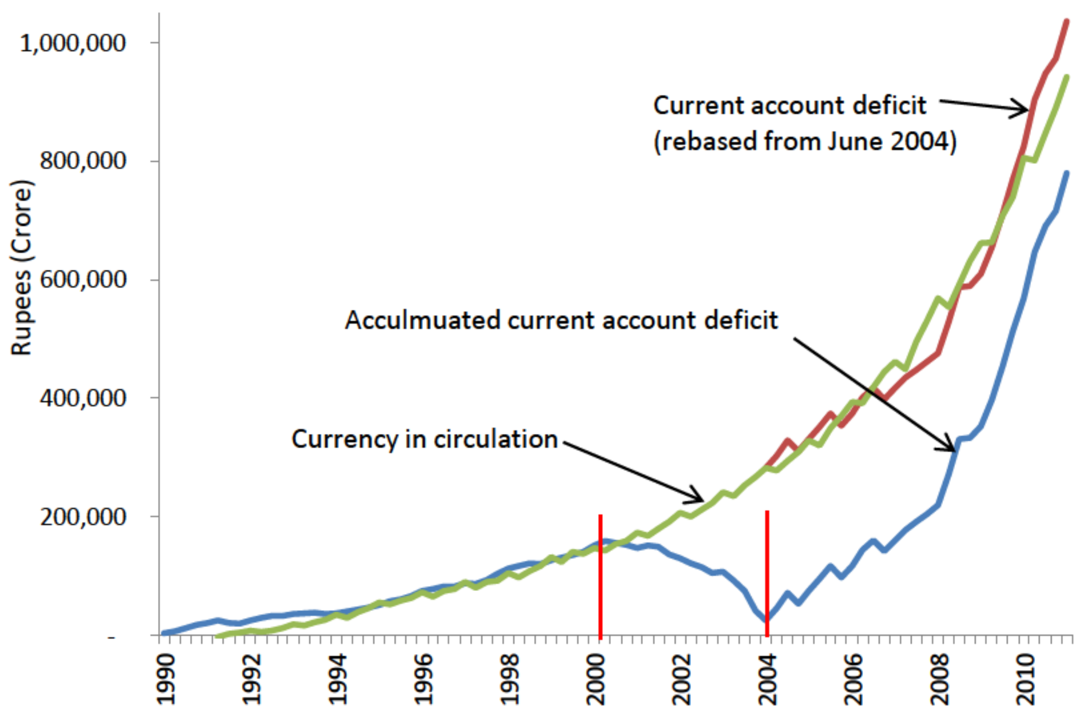

Figure 3. India: Current account balance and currency in circulation (growth of bank credit)

4.5 The lesson to be learnt for Australia is that if the government were to allow international transactions to affect the money supply by intervening in the exchange rate, Australian exports would generate more money than the banks would have created, causing a net injection of money into the economy, and the Australian economy would prosper. The increased prosperity would enable borrowers to repay their debts and avoid a financial crisis. Also, the prosperity would encourage increased investment which may enable banks to increase their lending and their profits by more than they currently under the existing form of support for the banking system. Therefore, such a policy would not only support exports such as defence exporters by making them more internationally competitive, it would support the banking industry.

4.7 A policy of guiding the exchange rate to a lower and more stable level does not "beggar thy neighbour". The Philippines had a monetary system like Australia's until 1997. It then subtly modified its monetary system, including guiding its exchange rate, and has been experiencing current account surpluses since 2003. Also, its spending on imports has fallen from 45 per cent of GDP to around 30 per cent of GDP. Yet despite this, Philippine growth has been so high that total imports have also increased, enabling its trading partners to prosper from its economic growth.

5 Fiscal deficit

5.1 Australia's large fiscal deficits at both the Federal and State levels reveals that Australia's governments do not have the resources available to meet their current commitments, let alone take on new commitments, such as to provide increased support for defence exports. The lack of fiscal resources highlights the disparity with Australia's vast mineral resources. It brings into question Australia's policy of prohibiting new money entering the economy from international trade. If that prohibition could be lifted, the income earned from mineral and other exports could stimulate the whole economy and provide government with the financial resources, not only to meet its existing commitments, but new commitments, such as increased commitments to defence exports.

5.2 The floating exchange rate system supports the banking system by removing the obligation on the banking system to convert domestic currency into foreign currency. It was intended to allow the exchange rate to depreciate to the point where foreign investors would be prepared to take the risk and invest in Australia. However, the banks no longer need that form of support because the amount of foreign currency seeking to enter Australia from exports and investment exceeds the amount of Australian currency seeking to leave Australia to pay for imports, etc. Consequently, the currency has been appreciating and undermining the competitiveness of Australian industry, thereby reducing incomes of Australian industries and reducing the tax revenue of Australian governments.

5.3 Australia has little to gain from an inflated exchange rate. If the exchange rate were capped, then Australia could have the best of both worlds: it could support its banks by allowing the exchange rate to depreciate when bank lending finance imports in excess of exports. However, when exports exceeded imports, the cap on the exchange rate would allow exporters to bring more money into Australia, raising incomes and employment and raising government's tax revenue, thereby reducing the fiscal deficit. Also, it would mean that Australia could increase its foreign assets and/or reduce its foreign debt.

5.4 The optimum exchange rate for Australia would be one that ensured that demand for Australian products was sufficient to provide full employment without causing excessive inflation. The government could apply the exchange rate cap at such an optimum level or this could be done by the Reserve Bank or by the market. If the market were to set the cap, the government would need to give incentives to the finance market that linked their profits to the government's employment and inflation targets.

5.5 A more open monetary system would support the wider economy and, if necessary, raise the capacity of governments to provide additional support to industry, including defence exports. The additional money and income earned from international trade would also improve Australians capacity to service debt. This would make banks more secure and the additional income would increase demand for investment and new bank loans. Thus, not only would export industries and import competing industries receive benefit from such a policy, the banking industry would receive additional support.

6 Conclusion

7.1 This submission has identified a number of barriers and impediments to the growth of Australia's defence exports. It has suggested options for how the Australian government could better engage and assist not only the Australian defence industry, but all Australian industry, to export its products.

7.2 The Australian economy has been undermined by a rash policy adopted to protect its financial system during a crisis. The policy applied was more than necessary to remedy the crisis. If the government wishes to continue to support the banking industry by deregulating bank lending and avoid a similar financial crisis, then a full float is not necessary. It could maintain the swap market for foreign currency but establish a cap in the form of a standing offer for foreign currency at, say, one dollar fifty cents Australian for every US dollar. Under that system, if the swap market drives the exchange rate below the capped level, it is free to do so. Such a policy would ensure that exporters, including defence exporters, earn a minimum amount for their exports (say, A$1.50 for every US dollar) when the cap applied and even more when the market drove the exchange rate to a lower level.

7.3 National Security is a major priority and should take precedence over the continuation of a policy that is hindering the whole economy and threatening the stability and security of the industry the policy was originally established to support. That policy is so damaging to the economy that it is undermining the ability of the Federal Government to effectively finance national security. Yet the policy has been so publicly defended and espoused as a pillar of Australia's economy that it would be difficult to justify dismantling it.

7.4 Some countries have already tacked that problem. The Philippines have justified it on the basis of maintaining order and stability[3]. Other countries claim to hold freely floating exchange rates, keep their intervention secret. They can be identified as the economies growing faster than can be explained by the growth of their bank debt. The USA openly intervened in its exchange rate between 1985 and 1996 as evident in agreements such as the Plaza Accord.

7.5 National security relies upon more than the defence industries. It requires the prosperity of the whole economy. National security can be enhanced by a monetary system that is open to benefit from international trade and allows the whole Australian economy to prosper from its vast resources and its trading success. Only a more open monetary system can generate the income necessary for government to earn the income necessary to be able to adequately finance national security and support defence exports.

[3] http://www.bsp.gov.ph/downloads/Publications/FAQs/exchange.pdf "the BSP's participation in the foreign exchange market is limited to temper sharp fluctuations in the exchange rate On such occasions of excessive movements, the BSP enters the market mainly to maintain order and stability

About the Author

Leigh Harkness is an economist who first gained professional experience as an economist in the small South Pacific Island Kingdom of Tonga in the early 1980s. In the Tongan Treasury he discovered that the growth of bank credit had generated imports that had depleted the Kingdoms foreign reserves. He was able to develop appropriate policies to regulate bank lending and since then Tonga has continued to have significant levels of foreign reserves relative to its imports that has enable it to trade freely.

Mr Harkness joined the Australian Treasury in 1984, and discovered there that Australia's current account deficit was equal to the growth of bank credit. The Treasury realised that this data questioned the wisdom of government's policy of bank deregulation. Hence Mr Harkness was eventually asked to leave the Treasury. Before doing so, he had, with the assistance of Treasury colleagues, developed a set of monetary policies designed to ensure monetary stability, full employment and low inflation.

After leaving the Australian Treasury in 1993, Mr Harkness has been working as an economist, mainly in the energy industry, but also on a contractual basis with the Department of Foreign Affairs and Trade and has on occasions returned to work for the Tongan Treasury.