THE FLOW OF FUNDS AND THE AUSTRALIAN ECONOMY IN 1988-9
COMMENT

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The Federal Government's major economic targets for 1988-89 are for an increase in the consumer price index and average earnings of 5.5 per cent and for the current account deficit of the balance of payments of $9.5 billion. These targets are being shattered by the continued high growth rate of the liabilities of the non-finance sector. While the net public sector borrowing requirements has been dramatically reduced, debt finance obtained by businesses from Financial intermediaries and institutions, the major component of which is bill finance has continued to increase substantially. As a consequence, the total liabilities of the non-finance sector have continued to expand at an average annual rate of some 17-18 per cent.

This trend has serious implications for inflation and for monetary policy which, given political and institutional constraints, has to bear the major burden of adjustment. So far fiscal policy and wage restraint have carried the major burden of adjustment in making room for the projected expansion in fixed business investment in 1988-89 by $6-7 billion over 1987-88.

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In the two years prior to June 1988, additional funds raised by businesses amounted to $106.8 billion, or 83 per cent of the $129.0 billion total funds obtained by the private non-finance sector. The remaining amount of $22.2 billion, or 17 per cent, went for housing (some $12.5 billion) and personal loans, mainly credit card-based ($1.7 billion).

Most of the debt finance raised by businesses (unincorporated and corporate trading enterprises) was obtained from financial intermediaries and institutions, the major component of which is bill finance used to facilitate share acquisitions and corporate restructuring. [2] Businesses rely mainly on debt finance because interest is an allowable deduction against companies' taxable income, but dividends are not, and therefore debt is cheaper than equity.

One effect is to cause increases in interest rates, a previously argued in *The Flow of Funds and Monetary Policy in Australia* (1987) As shown there, there is a positive correlation between the liabilities of the non-finance sector and the interest rate. This is an apparently anomalous result. It arises because high proportion of funds is invested as a hedge against inflation and to take advantage of tax shelters, int he process raising interest rates and causing an expansion in money supply, broadly defined, and non-finance sector liabilities. Thus, in an inflationary context, both liabilities and interest rates can increase concurrently." [3]

In 1985-86 interest paid by corporate trading enterprises accounted for 13 per cent of the value of the gross product of these enterprises. [4] While interest paid by businesses is an allowable deduction against company

2 See RBA *Bulletin*, August 1988, p.16.

3 G.A. Marzouk, *The Flow of Funds and Monetary Policy in Australia.* (Australian Professional Publishers, Sydney, 1987) p.204.

4 G.A. Marzouk, *The Consolidated National Accounts and Flow of Fund in Australia: 1974-75 to 1985-86*, Table II.7.

taxable income, the rise in interest rates would lead to an increased cost of production and a rise in mark-up rices, accentuating the rate of inflation.

In a highly deregulated financial market like Australia's,with no direct measures of credit control and no exchange control, there is no effective monetary policy to control changes in interest rates. Attempts to raise interest rates further would lead to larger net foreign exchange inflow, larger open market operations and a higher exchange rate for the Australian dollar, which would encourage imports and widen the balance of payments deficit.

The effect of this situation is problematic. Inflation is likely to threaten the Labor Government's electoral and economic strategy, accentuating pressures on wages, housing interest rates, the balance of payments and essential government expenditures.

In the three months to September 1988 the consumer price index rose by 1.9 per sent, which is equivalent to an annual inflation rate of 7.3 per cent. This is likely to accelerate in the remaining part of the current fiscal year to some 10 per cent (given an elasticity of the implicit GDP deflator with respect to L and surplus savings of the household sector of about 0.63) in the absence of measures to taper off the rate of inflation.

The Australian economy has lost track of its financial flows and domestic fundamentals as a result of Paul Keating's deregulation of the financial market and abolition of exchange controls. On 25 October 1988, Mr Keating stated that the Government did not see any need at present for a "discreet tightening policy" which would lead to strong rises in interest rates.[5] But he is missing the culprit in pushing for minimal wage increases next year in return for tax cuts. He ruled out putting further pressures on demand through interest rates, pointing out that consumption was "quite flat" as indicated by retail sales.

5 *Sydney Morning Herald*, 27th October 1988, p.1.

Three weeks later Mr. Keating, commented on the $1.7 billion deficit for October 1988 stated that

> "We have an investment boom ... It is investment after all that is the saviour of our balance of payments situation."

Mr. Keating ruled out using monetary policy - the key determinant of interest rates - to slow down spending. He added that

> "I believe the last week's further tightening in monetary policy is adequate in dealing with the current buoyancy of the economy, some of which is reflected in today's numbers. This tightening in policy, including fiscal policy coming from the $5.5 billion Budget surplus announced in August, has yet to impact substantially on demand." [6]

Monetary Policy has been used restrictively but it lacks selectivity. An alternative approach would involve the Government and the Reserve Bank directly tightening credit obtained by businesses for acquisitions.

However, in general, it is clear that macroeconomic management in a deregulated economic environment is extremely problematic. It is necessary that the Government evaluates in full the serious implications of its deregulatory thrust for the present and future of the Australian economy.

6 *Sydney Morning Herald*, 17 November 1988, p.1.