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AUSTRALIA'S CURRENT ACCOUNT AND
DEBT PROBLEM: A SCEPTICAL VIEW OF
THE PITCHFORD THESIS

H.W. Arndt

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H.W. Arndt
Australian National University

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AUSTRALIA'S CURRENT ACCOUNT AND DEBT PROBLEM: A SCEPTICAL VIEW OF THE PITCHFORD THESIS

H.W. Arndt

SUMMARY

Professor J.D. Pitchford, in a series of articles, has questioned the widely held view that Australia has a serious current account and foreign debt problem. He argues that (a) the current account deficit is the result of private capital inflow to finance productive investment which can be expected to yield a sufficient return to meet debt service; (b) even if spontaneous capital inflow were insufficient to finance the current account deficit, this would present no problem under the present floating exchange regime because depreciation would restore external balance; (c) external balance therefore is an inappropriate target for macroeconomic policy.

This paper contests all three propositions. The current account deficit is much larger than would result from spontaneous capital inflow because of domestic excess demand and lack of international competitiveness, and much of the capital inflow finances (public and private) consumption. The exchange rate regime is not a clean float because the authorities, rightly concerned about the potential inflationary effects of a sharp depreciation of \$A, are keeping interest rates high to attract portfolio capital from abroad. Finally, to suggest that external balance can be left to look after itself is no more plausible than the view (which Pitchford rejects) that internal balance can be left to look after itself because of Say's Law.

Professor J.D. Pitchford, in a series of papers (Pitchford 1989 a, b, c, d, e, f, g) has argued that Australians - politicians, economists, media commentators and others - are mistaken in thinking that the country has a serious balance of payments and foreign debt problem.

His thesis can be summarized in three propositions:

1. The current account deficit is the result of private capital inflow to finance productive investment which can be assumed to yield a return sufficient to meet debt service.
2. Even if spontaneous capital inflow were insufficient to finance the current account deficit, this would present no problem under a floating exchange rate regime because depreciation would restore external balance.
3. It follows that external balance is an inappropriate target for macroeconomic policy.

It is the purpose of this note to show that none of these propositions is plausible or realistic.

By way of background, first some indications of the magnitude of the problem. At the time of writing (October 1989), Australia's annual current account deficit is running at \$A20.3 billion, close to 6 per cent of GDP (as compared with 2 per cent in the USA). By the end of June 1989, Australia's net foreign debt stood at \$A108 billion, exceeded only the the foreign debts of Mexico and Brazil and equal to 32 per cent of Australian GDP. Australia and the USSR were the only major commercial debtor countries whose debt was still increasing. The proportion of Australia's export earnings required for investment income payable overseas had been increasing by 2 percentage points a year over the previous six years, from 10 per cent in 1982/83 to over 23 per cent in 1988/89 (Treasury, 1989; Moore, 1989). The Economic Planning Advisory Council estimated that, merely to stabilize Australia's foreign debt at 30-40 per cent of GDP by the mid-1990s, Australia's exports would need to increase in volume at not less than 6 per cent and imports by not more than 2 per cent a year, assuming no serious decline in the terms of trade (EPAC, 1989). Obviously, current account

surpluses would be needed to reduce foreign debt (other than by default).

I. Current Account Deficit Reflects Private Capital Inflow for Productive Investment

The first proposition contains two assumptions which are best considered separately: (a) Australia's current account deficit is the result of capital inflow. (b) The inflow consists of private sector borrowing for productive investment which can be assumed to be self-financing.

(a) Current Account Deficit Result of Capital Inflow

Pitchford dismisses concern about the current account deficit chiefly on the ground that "a current account deficit may be the desirable consequence of real capital movements" (Pitchford, 1989a, p.8; unless otherwise indicated all references are to this article). No one would dispute this. The current accounts of long-term capital exporting countries will normally be in surplus, those of capital importing countries will normally be in deficit. The latter is the situation of most developing countries (unless and until debt service begins to outweigh net inflow, the "negative resource transfer" case). It also was the situation of Australia through most of the 19th century, and still is to some extent to-day. Australia, as a resource-rich country, offers opportunities for more productive investment than can be financed from domestic saving. Overseas borrowing to finance such investment, whether private or public, would require a current account deficit, as the mechanism of real transfer, even in the absence of any other factors.

But such "normal" long-term capital inflow is not the only cause of current account deficits. A country's current account may deteriorate because of domestic excess demand spilling over into imports or because of a decline in the terms of trade or a fall in foreign demand for the country's exports due to recession abroad or because of loss of international competitiveness by its industries due to faster inflation or slower growth of productivity. A

current account deficit brought about by any of these factors has to be financed somehow, unless it is instantly eliminated by currency depreciation (the point of the second proposition to be considered below). Unless spontaneous long-term capital inflow happens fortuitously to increase to the necessary extent, steps have to be taken to attract capital inflow, e.g. by raising domestic interest rates, or the deficit has to be covered, in the last resort, by running down international reserves. The current account deficit represents the gap between domestic saving and domestic investment which has to be filled by drawing on foreign saving.

The implicit assumption, therefore, that the capital account always drives the current account is untenable. Capital inflow may be the result, rather than the cause, of a current account deficit. Either the capital or the current account may be exogenous or accommodating; both interact in complex ways through changes in relative prices and supply and demand in factor and product markets.

(b) Capital Inflow Consists of Private Borrowing for Productive Investment which can be Assumed to be Self-Financing

Much of Pitchford's case rests on his view that "government borrowing and debt raise altogether different questions from private borrowing and debt" (1989a, p.6) and that Australia's overseas borrowing is now entirely private.

The assertion that Australia's foreign debt and borrowing are wholly private is in need of substantial qualification. It is true that the Commonwealth Government ceased to borrow abroad last year (1988/89), indeed used some of its budget surplus to pay off foreign debt. But borrowing abroad by the rest of the public sector continued. Of the increase in gross debt during calendar 1988 of \$10.9 billion, 72 per cent was accounted for by increase in public sector debt (Treasury, 1989, Table 23). Of this increase, the greater part is believed to be accounted for by sales of Australian government securities to non-residents and could thus be regarded as private borrowing, but the effect was to increase the public sector's external liabilities. Similarly, the fact that, at the end of 1988, 47 per cent of Australia's

gross foreign debt and 40 per cent of net debt represented public sector debt might be thought irrelevant to the way the present current account deficit is financed, but it is very relevant to the proportion of export earnings mortgaged for debt service. In any case, the distinction drawn by Pitchford between public and private foreign borrowing is much too sharp.

No doubt, there is much historical evidence the world over of profligate borrowing by governments to finance budget deficits, public consumption and unwise public investment. But there are also many examples of government overseas borrowing for public works and other investment which paid off directly or through stimulus to growth of GDP and export or import-competing industries. The record of Australian colonial government borrowing in London during the 19th century, while by no means immaculate, on the whole bears this out. The same can probably be said of some at least of LDC borrowing from the World Bank and other lenders.

Conversely, by no means all private capital inflow is "optimal" and automatically self-financing. Pitchford has a mental picture of private capital inflow taking the form of a "firm" investing in a "project", such as a factory or a mine. Very little of Australia's current overseas borrowing (as contrasted with equity, including direct, foreign investment which is not included in the foreign borrowing and debt figures) is of this kind. Much of the money has come in through banks and other forms of portfolio investment and has found its way into office and other non-residential building or into public utilities and other infrastructure that contribute to growth of GDP only in the long run, into housing and other forms of consumer credit which does not yield a financial return¹ and into financial takeovers the effects of which on the real economy are often difficult to fathom. In so far as the purposes

¹ It has been argued that housing investment is necessary to sustain immigration and thus contributes to Australia's long-term development. The same might be said about many other forms of private and public consumption. The argument implies that to pay for high and rising living standards of a growing population by foreign borrowing represents prudent finance. The argument virtually obliterates the distinction between consumption and investment.

to which private investment has been applied can be inferred from the kinds of capital equipment imported, it is perhaps not insignificant that nearly one-half of total "machinery" imports during 1986-9 has consisted of data processing, general office, printing and book-binding, telecommunications and earth-moving equipment, scientific instruments, and record players, VCRs etc. (Miller and Associates, 1989).

As Moore and other have pointed out (Moore, 1989, pp.3, 17), the counterpart to the enormous increase in Australia's foreign debt during the 1970s and 1980s has been increased consumption rather than investment. The share in GDP of consumption, chiefly public consumption, rose between 1970-71 and 1985/86 from 72 to 79 per cent. While private investment has risen strongly in the last few years, the increase has been more than offset by cutbacks in public sector investment.

Pitchford blandly assumes that "the private sector will seek saving, investment and so foreign debt levels which are optimal from the viewpoint of the individual agents involved" (1989a, p.11). He admits that private investors may make mistakes (1989c, p.10) but does not think this relevant to the national interest because private investors "have a well-defined bankruptcy option" (1989a, p.6).² In the case of domestic investment, one may agree that, even allowing for the external diseconomies of resources squandered and social hardships cause through malinvestment, government intervention may not be the answer. It is another matter if the investment is financed by foreign borrowing.

If a firm borrows abroad to invest in a non-traded goods industry (say, in a housing or cinema project), it may earn an adequate return to meet its debt service in Australian dollars. That the debt service requires foreign exchange is of no concern to the firm which can readily

² Here again, the public-private distinction is overdrawn. Governments, as the economic history of the past two hundred years amply demonstrates, have a well-defined default option (nowadays more politely called "rescheduling"). One might note in passing that earlier protagonists for a market economy, from Adam Smith to Hayek, would not have glossed over the moral connotations of bankruptcy and default with the nonchalance implied in Pitchford's statement.

buy it in the foreign exchange market.³ But since, by assumption, the project does not enable Australia to earn or save foreign exchange, the fact that it has been financed by foreign borrowing constitutes an external diseconomy. There is a divergence between private and social marginal product, the social cost consisting in the adjustments (e.g. exchange depreciation and its consequences) necessary to meet foreign debt service. Pitchford totally disregards this crucial fact. "If a project is profitable it will meet costs and pay interest" (1989a, p.12) and that is that. Another potential externality is that default on foreign debt is liable to have repercussions on the whole country's credit rating, and thus on the cost and availability of foreign credit, which do not arise in the case of domestic debt.⁴

Where such consequences follow from "normal" (autonomous) long-term capital inflow, one may be disposed to accept Pitchford's conclusion that "in the main the private sector should be left to choose its borrowing and debt according to its preferences and productivity" (1989a, p.11) since microeconomic intervention, government regulation of foreign investment, is liable to do more harm than good. But where capital inflow is deliberately stimulated to accommodate a current account deficit, there may be a strong case for macroeconomic intervention.

II. Current Account Deficit No Problem Under Floating Exchange Rate Regime

Pitchford has a second string to his bow. Even if private "normal" capital inflow is insufficient to finance a current account deficit, there is no need to worry. Concern about external balance is a hangover from the days of pegged exchange rates, "now superseded in an era of floating rates" (1989a, p.6). This is familiar ground, and we can be brief. There are

³ It is sometimes pointed out that an increasing proportion of Australia's foreign debt is SA-denominated (40 per cent in 1988/89, as compared with 17 per cent in 1983/84 (Moore, p.49)). This transfers the exchange risk to the foreign lenders (reflected in a higher rate of interest) but in no way reduces the need to find foreign exchange to finance debt service or eventual repayment.

⁴ Such downgrading of a whole country's credit rating cannot be avoided by "stratification of risk premia from the most creditworthy to least creditworthy corporations" (Birrell et al. 1989, p.13).

at least three reasons for doubt whether a floating exchange rate can be relied upon as the adjustment mechanism for external balance.

First, a nominal depreciation may achieve a real depreciation only temporarily, if price increase spills over from traded to non-traded goods and services. This is more likely to happen the more open the economy (which is why exchange rate adjustment is virtually useless in Singapore) and the stronger the wage-price link through formal or informal wage indexation, as traditionally in Australia.

Secondly, even real exchange depreciation may not easily effect the necessary shift of resources into traded goods (export or import-competing) industries. In principle, given a clean float, a sufficiently large depreciation will, if accompanied by appropriate macroeconomic restraint, restore external balance by throttling off imports, but possibly only at great social and economic cost. A large depreciation may cause serious domestic inflation - cost-push accommodated by expansion of money supply - with the risk of cumulative effects through virtual "indexing" of the exchange rate; and expectations of continuing depreciation are liable to lead to speculative outflow of foreign or domestic capital (hastened if there are fears of capital outflow control). In practice, because governments fear these consequences, the float is hardly ever clean. Depreciation is almost always limited, either by central bank intervention in the foreign exchange market or by capital inflow attracted by high interest rates. In these conditions, the current account deficit may continue for some years, financed by accumulation of foreign debt and corrected, as Pitchford concedes, only "eventually" (1989a, p.12).

Thirdly, if a restrictive monetary policy is too successful in attracting capital inflow, possibly because it is being used concurrently to maintain internal balance - one instrument for two objectives - the exchange rate adjustment mechanism may be completely frustrated: capital inflow may cause the currency to appreciate, as has happened in recent years both in Australia and the USA.

To these reasons for not dismissing the problem of external balance as adequately disposed of by a floating exchange rate regime might be added two considerations which have recently been prominent in international discussion. One is the case for a return to more stable exchange rates based on what is thought to be the excessive volatility of exchange rates in the 1980s, with its adverse effects on business decision-making and trade. The other is the view that abandonment of pegged exchange rates has removed the main external discipline on national macroeconomic management, a discipline not in practice easily replaced by international policy co-ordination.

III. External Balance not Appropriate Target for Macroeconomic Policy

Having established to his own satisfaction that "privately generated current account deficits and foreign debt" present no problem and that there can, in any case, be no problem of external balance in a floating exchange rate regime - in other words, having assumed the problem away - Pitchford concludes, quite logically, that external balance is not an appropriate target for macroeconomic policy. At most, there may be a case for microeconomic reform to eliminate distortions caused by government regulations, such as the tax system which does not allow deductibility of the inflation component of interest (1989a, p.11).

Pitchford's concern is that macroeconomic policies of restraint aimed at reducing the current account deficit needlessly reduce growth and may cause recession and unemployment. "What percentage rate of reduction in the growth rate of GDP are we prepared to give up because of non-specific fears about growth in private foreign debt?" (1989f). Pitchford does not question the need for "intervention to regulate the level of activity for reasons of internal balance" (1989a, p.13), though he is not quite so sure whether, in the case of excess demand leading to inflation, "the costs of this situation always

justify macro intervention" (1989a, p.13).⁵

He is rightly troubled about excessive reliance on a restrictive monetary policy by a government which believes it has gone as far as it can politically with fiscal and wage policy. "If monetary policy is tight to check growth and so reduce the deficit on current account, the high interest rates so produced will generate a capital inflow and appreciate the nominal exchange rate." (1989a, p.13). The statement is a welcome admission that capital inflow may be the result, not the cause, of a current account deficit, specifically the result of government efforts to contain the deficit and avoid the consequences of exchange depreciation ("keeping up \$A"). But it glosses over the fact that the Government's use of a restrictive monetary policy for demand management serves two purposes, to contain inflation (internal balance) and to limit imports (external balance).

This indeed is the most surprising feature of Pitchford's position: he allows only one objective for macroeconomic policy, internal balance. Macroeconomic policy has no role in relation to external balance. In other words, he implicitly accepts Keynes's argument that market failure in the capital and/or labour markets may justify government intervention to maintain internal balance, but denies the possibility of market failure in relation to external balance. In this sense, the Pitchford thesis is the counterpart of Say's Law.

One may sympathize with Pitchford's view that government failure may outweigh market failure. But the argument that "the private sector is on average more capable of making sensible, well-informed choices about its investment and borrowing than could be

⁵ When Pitchford complains about the use of macro policies "to reduce demand (and so real growth) below the level consistent with internal balance" and refers to "a level of excess demand for domestic output, reflected in a tendency for the prices of these goods to rise" (1989a, p.10), he seems to have forgotten the lesson taught to generations of Australian economics students by the Swan diagram. It is the current account deficit that maintains internal balance in conditions of excess demand in an open economy. The excess demand spills over into imports rather than raising prices. To correct external imbalance, it is necessary to reduce domestic spending and effect (or permit) an appropriate adjustment of the exchange rate.

made by public servants or politicians on their behalf" (1989a, p.13) is plausible only in relation to microeconomic decisions. If government intervention is often necessary for internal balance, why not for external balance?

Pitchford admits that Third World countries have debt problems. But he argues that these have arisen from "public borrowing to fund welfare programmes" (1989c, p.10)⁶ and gives no hint as to how large a foreign debt must be to become a problem. In relation to Australia, with its "privately generated current account deficits" (1989a, p.13), he insists that external balance is not "an easily identified concept ... Who can know what level, or per cent of GDP, the current account deficit 'should' be?" (1989a, p.7). (The same could, of course, be said about internal balance - remember the Phillips curve!)

The view is widely held among international lenders, public and private, that certain ratios may serve as safe limits or at least as warning signals: a gross-debt/exports ratio of 200 per cent, a debt-service/exports ratio of 20 per cent, a CAD/exports ratio of 20 (or at most 30) per cent, a CAD/GDP ratio of (say) 5 per cent (cf. Moore, 1989, p.11). Pitchford is unimpressed "It is not self-evident that deficits of the order of 4 per cent to 6 per cent of GDP and the present foreign indebtedness levels⁷ are undesirable" (1989a, p.10). The same might be said about 10-15 per cent inflation rates or 5-10 unemployment percentages.

Externalities

Pitchford phrases his arguments with studied moderation - this or that "may" happen or be the case - and qualifies his statements; clauses such as "with some important exceptions", "leaving aside distortions", "given the qualifications" abound. But they are a

⁶ Excessive foreign borrowing by Mexico, Indonesia and many other Third World countries during the oil boom of the 1970s resulted from over-optimistic assessment, by lenders and borrowers, public and private, of the profitability of major industrial investment projects.

⁷ Australia's gross-debt/exports ratio in 1988/89 was 254 per cent (Moore, 1989, p.53).

matter of form rather than substance. He finds no distortions other than those caused by government regulations and no externalities except that "foreign debt or ownership may invite undesirable political influence or may be undertaken without a full appreciation of the marginal cost of borrowing" (1989a, p.12).

It may be worth listing some of the more important external diseconomies that private borrowing abroad may impose on the borrowing country.

1. Errors of judgment by private investors. Malinvestment, besides the losses that bankruptcy inflicts on creditors and debtors, causes waste of resources and may impose hardships on employees and others. (Some takeovers financed by foreign borrowing may fall into this category.)
2. Investment in non-traded goods industries financed by capital inflow (more likely for portfolio than for direct investment, particularly if attracted by high interest rates). Even if such investment is profitable in domestic currency, pressure on the current account to meet debt service may impose the various external diseconomies of currency depreciation (domestic inflation, effects on income distribution including increased tax burden of foreign-currency denominated public debt, possibly exchange speculation and/or exchange control). These external diseconomies which differentiate externally from domestically financed investment do not constitute a case against such investment, any more than environmental costs, but they need to be taken into account in evaluating its marginal social product.
3. Foreign borrowing to finance consumption. This involves the same externalities. It may occur not only in the case of government borrowing but also when private capital inflow is channelled into housing and other consumer credit.

4. Increased vulnerability of the economy to decline in the terms of trade (as the proportion of export earnings mortgaged for debt service rises) and to sudden cessation or reversal of capital inflow caused by loss of confidence among foreign lenders. While a decline in the terms of trade may present a case for borrowing abroad to cushion the shock, it may also, as Australia's experience in the early 1890s and 1930s showed, make access to foreign credit more difficult.
5. The economic and social costs of resource shifts into tradable goods industries necessary to correct the current account deficit. These should be manageable if the adjustment occurs gradually but are liable to become intractable if the necessary adjustment is too long delayed by continuous borrowing abroad and therefore becomes very large.
6. The "debt trap". In extreme cases, foreign debt service may outweigh capital inflow, leading to "reverse resource flow".

Few believe that Australia is already exposed to all these risks. But it is difficult to be content with an analysis that abstracts from them completely.

International vs Interregional Balance of Payments

At the very end of his article Pitchford hints at another argument for not worrying about the current account deficit. Is all the fuss "the outcome of the historical accidents which resulted in national boundaries?" (1989a, p.13). In other words, why do we worry about deficits in the balances of payments of nations but not of regions within a country?

The usually textbook answer is threefold:

1. Within a country, equilibrating capital flows, inside the banking system, are virtually automatic.

2. Structural adjustment is easier within a country because of greater mobility of labour (as evidenced by more uniform levels of real wages).
3. A single macroeconomic policy (reinforced by a single currency) minimizes the risk of imbalances arising from divergent movements in money supply and aggregate demand.

The first of these differences has become less important with liberalisation of international capital movements and integration of the international capital market. The third can, in principle, be reduced by international co-ordination of macroeconomic policies. But until the whole world achieves what Europe hopes to achieve in 1992, nations will continue to have problems of external balance.

Finally, two arguments in support of Pitchford's thesis may be mentioned which are only implicit in his statements but have been made by others.

One is that a country can sustain a large current account deficit for decades by selling assets - land or other parts of the capital stock - to foreigners. If Japanese are willing to finance Australia's current account deficit by buying Sydney harbour front or rural properties, why not let them? (c.g. Gutman, 1989). Even where ownership involves no significant control, public sentiment is liable to revolt against a prolonged spree of "living off the family silver", however difficult it may be to justify such an attitude on purely economic grounds.

The second was recently put forward, in relation to the USA, by the American economist Herbert Stein. "The US has a trade deficit because people in the rest of the world invest their savings here ... As a result of the trade deficit, the stock of productive capital in the U.S. is \$700 billion higher than it would otherwise have been ... Let's forget about the trade deficit" (Stein, 1989). Like Pitchford, Stein simply assumes that all capital into the USA goes into self-financing productive investment; he abstracts from all the externalities listed above. He is not afraid to draw the logical conclusion from his argument: "Poor weak

countries - like Brazil - can have trade surpluses. Rich, strong countries like us can have trade deficits" (ibid.). Japan and Indonesia please note!

Conclusions

I conclude that Pitchford's thesis is untenable. Australia has a serious balance of payments and foreign debt problem.

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