The Australian

Opinion

NSW was our Greece in 1930

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- From: The Australian
- October 07, 2011 12:00AM

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WE'VE been there, though so long ago that what happened is taught, usually badly, in schools. But Australia's experience with debt and default in the Depression helps explain why markets are spooked by Europe's crisis. For if we got over our difficulties, it was because of factors Europe entirely lacks.

NSW was our Greece, though with nearly half of Australia's then national income, on a greater scale. Like the other states, it had spent heavily in the 1920s, including on unprofitable railway lines and unviable soldier settlement schemes. And like the other states, British loans financed much of that spending. As a result, overseas debt servicing costs nearly doubled during the 20s, with interest payments rising rapidly relative to export income and government revenues.

Initially credit was easy to come by. But by the late 20s, Australia's creditworthiness seemed precarious. Keynes thought Australia "heavily over-borrowed", and "advised her securities be avoided". With the election of the Scullin Labor government, interest rates on Australian debt rose above those demanded from New Zealand and South Africa, though those countries were no less dependent on London borrowings.

The crash then slammed the gate on Australia's access to loans. In January 1929, the commonwealth raised an pound stg. 8 million loan in London. After that, long-term loans were virtually unavailable until the end of World War II. As the Depression slashed exports, foreign exchange reserves and government revenues, Australian governments had to rely on overdrafts and short-term bills to finance imports and meet interest commitments.

The result was an incessant need for renewed funding, but in a market profoundly sceptical of Australia's capacity and willingness to pay. "Australia," the Bank of England's Otto Niemeyer said, "must reassure the world as to the direction in which she is going, financially and economically, and no one else can do that for her."

Faced with those pressures, in June 1931 the commonwealth and the states agreed to the Premiers' Plan, with its 20 per cent reduction in all adjustable government expenditures, including wages and pensions, and increased taxes. But while NSW had approved the plan, the Lang Labor government, which had come to office in October 1930, had no intention of implementing it.

NSW had the most generous welfare scheme in Australia, as well as high public sector wages. And though its taxes were also higher, it had made less provision than other states for repayment of outstanding debts. With Lang and the unions refusing spending cuts, its financial position became untenable. In February 1931, the state failed to make interest payments due to depositors in the Government Savings Bank.

A year later, Lang told prime minister Joseph Lyons, who had just led a conservative coalition to victory, that NSW would not meet interest obligations on its foreign debt.

With Australia heavily dependent on short-term loans, NSW's default threatened the country's entire financial system with collapse.

But the Greek scenario did not play itself out. This was first and foremost because the commonwealth, unlike Europe today, had credible means of enforcing fiscal disciplines. These rested on the Financial Agreement of 1927, crafted by Stanley Melbourne Bruce, in which the commonwealth agreed to take over the states' outstanding debts, and guarantee new debts, in exchange for ongoing contributions by the states to a National Debt Sinking Fund. The states also agreed to co-ordinate all borrowing until 1985 through the Australian Loan Council, on which the commonwealth would have three votes, allowing it to secure a majority with the support of only two states. And as a further check on extravagance, any state borrowing to finance a revenue deficit had to pay interest into the fund at punitive rates.

All this was empowered by a new section 105A of the Constitution, which gave the commonwealth the right to make any law needed to enforce the Financial Agreement, "notwithstanding anything in this Constitution or the Constitution of the several states or any law of the commonwealth or of any state". It was this extraordinary provision that proved Lang's downfall. Relying on those sweeping powers, the commonwealth's Financial Agreements Enforcement Act allowed it to place a state in receivership. And with the debts on which Lang proposed to default benefiting from a commonwealth guarantee, the commonwealth moved to seize NSW's revenues. When Lang instructed NSW public servants to prevent that happening, that is to breach the law, the governor of NSW, Philip Game, dismissed him.

But it was not only the constitutional powers that allowed the commonwealth to exercise its threat. It was also the overwhelming public support for its action. After all, section 105A had been validated by a referendum, where it got a solid majority. And though Lang thought his dismissal would lead to revolution, he was resoundingly defeated in the subsequent election.

In short, while we had all the fiscal risks inherent in a system with multiple, interdependent jurisdictions, by the time crisis struck we also had the instruments, however blunt and unduly centralist, for managing them, as well as the electoral support needed to make their use credible. Once it was clear they could and would be used, the disciplines were all the more effective.

And therein lies the problem. For Europe lacks both the institutions and the popular mandate to enforce fiscal disciplines. Rather, the euro was from the start a project of the European elites, viewed with suspicion by large parts of the European population. Poorly designed, it was never equipped to manage the fiscal risks it created. Nor could it have been, given the fragile consensus on which it rested. Now that the risks have come home to roost, the elites whose project it was no longer have the political capital to make it work.

They are therefore caught in a trap of their own making, where all they have left are bailouts, and even those they cannot do credibly. As they lurch from eye-rolling drama to profligate but ineffective solution, markets are right to be frightened.

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