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Australia has been a net international borrower for most of the period since British settlement. Foreign borrowings and direct foreign investment have allowed a large number of investment projects to proceed which otherwise would either not have taken place or would have required considerably lower levels of expenditure, and therefore lower living standards, for Australian households.

The benefits of international borrowing are obvious. At regular intervals, however, costs of reliance on foreign capital have become apparent. Real and perceived problems associated with foreign debt exacerbated the difficulties generated by the depressions of the 1890s and 1930s and the 'recession we had to have' from 1989 to the early 1990s.

At other times, notably in the 1970s, the main focus of concern has been foreign equity investment which has resulted in foreign ownership or control of many important Australian businesses and, in some cases, entire industries. This concern has re-emerged in recent years, with a particular focus on the notion of a 'branch-office' economy. The central claim is that foreign ownership will result in the replacement of companies headquartered in Australia by branches of transnational enterprises based in the United States, Japan and Europe.

Along with this concern has been a strongly argued view that, provided Australia's financial and macroeconomic policies are sound, there is no reason to be concerned either about foreign debt or about foreign equity investment. At the core of this view is the argument that net foreign borrowings are simply the aggregate outcome of investment and borrowing decisions made by individual households and businesses, who should be assumed to be acting in their own best interest. If particular transactions are based on mistaken beliefs about the profitability of investments or the credit-worthiness of borrowers, that is a problem for the parties concerned, but should not lead governments to intervene.

The object of this paper is to reconsider arguments about foreign investment in the light of the 'branch-office economy' debate. It will be argued that concerns about a branch office economy are valid. However, the determination of appropriate responses is a complex task. Consideration is given to a number of policies including more critical scrutiny of particular foreign investment proposals, policies designed to increase Australian national saving, policies designed to increase the proportion of Australian portfolios allocated to domestic assets and finally, policies relating to privatisation and public ownership.

The long boom and the debate over international capital flows

The current debate over foreign investment must be understood in the light of institutions and attitudes developed during the 'long boom' from 1945 to the early 1970s. For nearly thirty years after World War II, international flows of capital were tightly constrained. Unregulated capital markets were widely seen as inherently unstable and as a major contributor to the Depression of the 1930s. Hence, the financial structure established at the Bretton Woods conference in 1944 allowed for tight controls on international movements of capital, along with fixed exchange rates and a presumption that individual countries would determine their own macroeconomic policy.

During the long boom, international flows of capital were small in relation to aggregate world output. Short-term flows were tightly restricted, so that gross flows (the total volume of international financial transactions) were roughly equal to net flows (the amount of capital actually transferred between countries over a given period).

In this context, arguments about foreign investment mainly focused on proposals for direct foreign investment in new projects. Advocates of foreign investment pointed to the potential transfer of technology and skills associated with the establishment of Australian subsidiaries by firms such as General Motors and IBM. In the strongest version of the 'technology transfer' argument, it was suggested that the skills learned from branches of

foreign firms could be used Australian companies to compete initially for the domestic market and ultimately in international markets.

Opponents pointed to concerns about the loss of national sovereignty and vulnerability to changes in investor sentiment. Moreover, they argued that the interests of stakeholders in the local subsidiaries established through foreign direct investment would be subordinated to the interests of the parent. In place of the commonly-used term ‘multinational’ which implied an enterprise with more-or-less comparable operations in different countries, these critics preferred terms like ‘transnational’ and an analysis which assumed that decision-making power was effectively exercised in US and European headquarters. This was, in some respects, an anticipation of the ‘branch office economy’ debate that has arisen recently.

The political compromise reached in Australia in the 1960s was a system of case-by-case evaluation of foreign investment proposals. The general assumption underlying the regulation of foreign investment was that, other things being equal, Australian ownership was preferable, but that the benefits associated with foreign investment would often outweigh the cost.

The debate over foreign investment was changed radically by the breakdown of the Bretton Woods system in the early 1970s and the abandonment of controls on international capital flows which took place during the 1970s and early 1980s. For Australia, the most notable step in this process was the floating of the dollar in 1983, which was followed by fairly comprehensive financial deregulaton. The presumption that Australian ownership should be preferred to foreign ownership, particularly in the case of foreign takeovers, was replaced both in form and in substance by a general presumption in favour of non-intervention...

The current account deficit

A striking feature of the period since financial deregulation has been the growth in

net international borrowings by the English-speaking countries. The counterpart to these borrowings is growth in the current account deficit, and the cumulative outcome of persistent deficits is growth in net overseas obligations. Australia and New Zealand had always been net borrowers, but their current account deficits rose sharply after deregulation from around 2 per cent of GDP to around 5 per cent. The United States, which had been a net lender since 1914 ran its first current account deficits for nearly a century in the mid-1980s. In the recent boom, the US current account deficit has approached 5 per cent of GDP. Even the United Kingdom, a net lender for the past two centuries except in wartime, now fluctuates between surplus and deficit on the current account. A crucial issue in the debate over foreign investment is whether this shift towards borrowing represents a reallocation of capital to economies with promising investment opportunities or a short-term consumption binge which will end badly.

The rapid growth in Australia's net international borrowings which followed deregulation came as a surprise and was a cause of considerable concern in the 1980s. This concern was accentuated by evidence that much of the borrowing was financing an unsound speculative boom in which business was increasingly dominated by 'entrepreneurs' such as Bond, Elliott, Holmes a Court and Skase.

When interest rates were increased sharply in the late 1980s, a vigorous debate emerged concerning the appropriateness of contractionary policies designed to reduce the current account deficit. The most prominent critic of such policies was John Pitchford of the Australian National University, who presented the argument that the current account deficit was simply the aggregate outcome of borrowing and lending transactions arising from the investment and consumption decisions of individual households and businesses in Australia and overseas. In the absence of market failures, the parties to these transactions should be assumed to be acting in their own best interest. If market failures are present, they should be addressed directly, through changes in the regulation of financial markets, rather than through contractionary macroeconomic policies.

In retrospect, most observers have conceded the validity of Pitchford's arguments against the use of contractionary monetary policy to control the current account deficit. Attention has shifted to the question of whether there are, in fact, important market failures associated with financial deregulation, and whether the appropriate response is the reimposition of some form of regulation or a more comprehensive policy of deregulation. Discussion of this question has been largely subsumed by the more general debate over the impacts of international capital markets on macroeconomic policy and macroeconomic outcomes.

Capital markets: sources of discipline or sources of random shocks

The growth in the volume of financial flows was accompanied by growth of the esteem in which financial markets were held. It was argued that the deregulation of international financial flows forced governments to submit to the discipline, sometimes painful but ultimately beneficial, imposed by international financial markets. Claims about market discipline supplemented more general arguments that government intervention restricting the investment decisions of firms and households were inherently undesirable.

Belief in the beneficial effects of financial market discipline was boosted by the inflationary experience of the 1970s and 1980s. With the failure of governments to control inflation, financial markets stood out as the only institutions resisting a continued inflationary spiral. Indeed, financial markets are naturally focused on inflation. In the absence of default by governments, the value of financial instruments such as bonds and currency futures are determined, in the long run, almost exclusively by rates of inflation. It does not matter whether a country has high or low unemployment, weak or strong growth. If price levels are stable, the exchange rate must also remain stable in the long run, and investors in bonds will receive the returns they expected when they made their investmetn decisions. Thus, in an inflationary period, the idea of financial markets as guardians of economic rectitude has some substance.

Subsequent developments, particularly since the middle of the 1990s, have led to qualifications of claims about the power of financial markets and the extent to which financial markets are accurate and impartial judges of the merits of economic policy. With inflation rates at low levels in most developed countries, the role of financial markets as a source of monetary discipline has become less important. Moreover, as the example of New Zealand has shown, excessively zealous pursuit of low inflation and the approval of financial markets can produce economic stagnation.

The most important factor in the development of a more balanced view of financial markets has been the series of international financial crises, of which the Asian crisis beginning in 1997 was the most important. The Asian crisis undermined the 'market discipline' view since the countries that were hit hardest were precisely those that had previously been regarded most favorably by financial markets. If the demands of financial markets are unpredictable, the idea that governments can prosper by complying with those demands is logically incoherent. The boom and bust in the NASDAQ index (which doubled in value between March 1999 and March 2000, then lost all its gains in the following year) has generated further scepticism about the rationality of financial markets.

The imposition of exchange controls by the Malaysian government in 1998 was a pivotal event. The 'market discipline' theory held that any such policy was grossly mistaken and that, in any case, the financial markets would not allow such a policy to be implemented. In the event, the policy was successful in achieving at least some of its short term goals and Malaysia was able to re-enter global financial markets without any apparent retribution.

Portfolio reallocation, mergers and the branch-office economy

During the long boom, the debate over foreign investment was seen primarily in terms of costs and benefits to national economies. With the widespread dissemination of the view that national boundaries are irrelevant, advocates of unrestricted foreign investment

have increasingly focused on the benefits to individual investors and corporations of an internationally diversified portfolio of assets.

In a fully globalised world, individuals' choices of portfolios would be determined by their own financial needs and attitudes to risk and would not be determined, to any significant extent by the fact that they happened to live in a particular country such as Australia. If Australia produced 2 per cent of world output, then the average investor, whether in Australia or overseas, would allocate 2 per cent of their investment portfolio to Australian assets.

It might be hoped that if 2 per cent of world output were generated in Australia, 2 per cent of all firms would also be based in Australia. Assuming Australia could supply managerial skills proportionate to its size, this would be the outcome in a simple competitive model of the world, in which a large number of firms competed in every industry.

Just such a model was put forward by advocates of globalisation in the early 1990s, who argued that the day of the big corporation was over and that concepts such as natural monopoly were obsolete. In practice, however, the era of globalisation has been one of unprecedented global mergers, which seem likely to produce a situation (familiar to Australian consumers) in which many global industries are dominated by a handful of firms.

The headquarters of these global enterprises are increasingly concentrated in a few 'global cities' – New York, London, Frankfurt and so on. Peripheral countries like Australia seem likely to be reduced to the role of 'branch-office economies' with no significant share in the market for corporate headquarters and no share in the associated high-paying jobs and high-employment supporting service industries.

The same trend to centralisation is evident within Australia, where Sydney has become increasingly dominant, as mergers have eliminated many firms based in smaller cities, and Melbourne, its one-time rival, has fallen steadily further behind. Similarly, having grown at the expense of smaller centres in New Zealand, Auckland is now losing

business to Sydney.

These developments are surprising in view of the dramatic reductions in communications costs, associated with the Internet and advances in fibre-optics and other telecommunications technologies. Far from enabling management functions to be geographically dispersed, these advances appear to have promoted more centralised management structures with local branches being run from head office on a 'fly-in, fly-out' basis.

There are at least two possible explanations for this paradoxical outcome. The first is that, despite improved communications, the need for face-to-face contact has not been displaced, at least for those in senior management who can afford to demand it. The second is that business headquarters gain benefits from being located together such as the friendly political environment that arises when the economy is dominated by financial capital.

The tendency towards global mergers also creates dilemmas for competition policy. Proposals for mergers between Australian firms are increasingly being supported by the argument that such mergers are necessary to meet competition from larger foreign enterprises. If accepted, such an argument naturally gives rise to a policy approach based on the creation of 'national champions' and the subordination of concerns about the effects on consumers of reduced competition.

Possible responses

If we conclude, on balance, that the costs of further increases in foreign ownership of Australian businesses outweigh the benefits, what policy responses are available? The imposition of tighter *ad hoc* restrictions on particular takeovers is unlikely to be effective in isolation, given the structural requirement for capital inflows to match continuing current account deficits.

An appropriate response must consist of two main elements. First, Australia must

seek to reduce its dependence on net inflows of foreign capital by increasing private and public savings. Second, the global financial ‘architecture’ must be reformed in a way that reduces gross international flows of capital. A ‘Tobin tax’ on international flows of capital could help to reduce short-term capital movements.

It is also necessary to re-examine the debate over public ownership and privatisation. Many recent privatisations have been accompanied by restrictions designed to ensure continued Australian ownership of the privatised firms. It is becoming increasingly evident that such restrictions are untenable in the long term. Hence, if an enterprise is too important to be allowed into foreign ownership, it is probably too important to be privatised in the first place.