

CANTILLON ON FOREIGN BORROWING

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... the quote

The first is when entrepreneurs and private individuals borrow money on which they pay interest to their foreign correspondents, or when foreigners send their money into the state so as to purchase shares or government stocks there. Frequently these amount to considerable sums which the state has to pay annually in interest to foreigners. These methods of expanding money in the state make money really more abundant there and lower the rate of interest. This money enables the state's entrepreneurs to borrow more easily, to have people make articles and to establish manufactures in the hope of profiting from them. The craftsmen and all through whose hands this money passes will consume more than they would have done if they had not been employed by means of this money, which consequently raises the prices of all things as if it belonged to the state. By means of this increase in expenditure or consumption resulting from it the tax revenues arising from consumption are expanded. The sums lent to the state in this way produce many benefits from it, but their consequences are always onerous and inconvenient. The state has to pay an annual interest to the foreigners and, aside from this loss, the state finds itself at the mercy of foreigners who can drive it into poverty when it takes their fancy to withdraw their funds. It will certainly happen that they will wish to withdraw them at the very time that the state will have most need of them such as when preparations are in hand to have a war and some hitch is feared. The interest paid to the foreigner is always considerably greater than the expansion in public revenues that this money causes. These money loans are frequently seen to pass from one country to another according to the confidence of the lenders about the states to whom they are sent. But, truth to tell, it often happens that the states, burdened by these loans on which they have over many years paid high interest rates, fail through bankruptcy in the long term to pay this capital. As soon as distrust sets in the stocks or public shares fall, the foreign shareholders do not like to withdraw them at a loss and prefer to content themselves with the interest while waiting for confidence to revive; but sometimes it never recovers. In states which fall into decay the principal object of ministers is usually to restore confidence and by this method to attract money from foreigners by these types of loans: for, unless the Ministry fails to keep good faith and to honour its engagements, the money of the subjects will circulate without interruption. It is the foreigners' money that may expand the quantity of actual money in the state. But recourse to these borrowings, though creating short term advantages, ends badly and is but a flash fire.

(Cantillon, Essai. 1755: 253-5. Translation by Antoin Murphy)

**A Deconstruction of Cantillon's
Analysis on the Dangers of Foreign
Borrowing...**

Quote 1 : *‘This money enables the state’s entrepreneurs to borrow more easily, to have people make articles and to establish manufactures in the hope of profiting from them.’*

Implication: Foreign borrowing initially creates a feel good factor and economic activity is increased.

Quote 2: *'The craftsmen and all through whose hands this money passes will consume more than they would have done if they had not been employed by means of this money, which consequently raises the prices of all things as if it belonged to the state.'*

Implication: Expenditure rises and prices increase.

Quote 3 : *'By means of this increase in expenditure or consumption resulting from it the tax revenues arising from consumption are expanded.'*

Implication: Tax revenues increase – a development that encouraged reductions in income tax and reliance on property taxes in Ireland.

Quote 4 : *'The sums lent to the state in this way produce many benefits from it, but their consequences are always onerous and inconvenient. The state has to pay an annual interest to the foreigners.'*

Implication: Despite the benefits there are costs in the form of external interest payments.

Quote 5 : *'...aside from this loss [external interest payments], the state finds itself at the mercy of foreigners who can drive it into poverty when it takes their fancy to withdraw their funds. It will certainly happen that they will wish to withdraw them at the very time that the state will have most need of them'*

Implication: There is potentially an even greater cost namely the possibility of capital flight at a time when the state is most in need of support -Ireland's current situation

Quote 6 : *'The interest paid to the foreigner is always considerably greater than the expansion in public revenues that this money causes.'*

Implication: The long term consequences of foreign borrowing are far greater than the short term gains.

Conclusion

- Cantillon provided a template which if read by politicians, bankers, central bankers and regulators could have saved Ireland a considerable amount of grief in recent years. Excessive external borrowing has now created a huge time bomb for the Irish taxpayers.
- Access to external borrowing increased in the 1990s when capital control regulations were removed in the move towards European Monetary Union. Ireland's membership of the euro appeared to offer borrowers (property buyers, developers, bankers) an almost infinite access to international money.
- The banks's lending was no longer constrained by their internal deposit growth and customers who found that they could not borrow from the Irish banks gained access to foreign banks prepared to lend into the Irish market.
- A fundamental principle of banking was forgotten as banks increasingly borrowed short and lent long. After the collapse of Lehman Brothers attention was directed to the Irish financial institutions' s balance sheets. Borrowing became more difficult and an incipient capital flight emerged.
- The one hundred per cent liability guarantee introduced on September 29, 2008 was aimed at preventing a systemic failure of the Irish banking system. Now the costs of this guarantee are becoming so great that it creates the risk that the taxable capacity of the country is insufficient to meet the growing claims.
- Pressing the default button for Anglo Irish Bank's senior bond holders is not a viable option in my opinion. Such a default will just serve to turn further attention to the balance sheets of AIB, Bank of Ireland, etc and increase further the cost of sovereign borrowing. A further harsh budget along with a drive to increase economic growth appear to be the only alternatives.