Institutional ECONOMICS

Archive

Articles for the Month:

Brian Toohey
argues for the abolition of company tax in terms that would do any 'economic rationalist' proud: *Amid all the screams that a concessional tax rate of 8 per cent on superannuation income is "too high", the government is overlooking an obvious case for reform highlighted by the latest setback for the National Australia Bank. The bank is challenging an Australian Taxation Office ruling that interest is not deductible on some hybrid securities issued seven years ago. NAB would have put a lot of time and effort into ensuring it met legal advice on what was deductible. The ATO would have done the same in coming to the opposite view of the law. Now more time, energy and money will be spent by each side trying to convince the courts about who has made the right interpretation of a painfully complex law. The simplest way to avoid this type of non-productive wrangle is to scrap company tax altogether. Then there could be no argument over deductions because there would be none. A key advantage of scrapping company tax is that it can be done in a way that has little, or no, cost to revenue. Productivity should be enhanced by eliminating "dead weight" compliance costs and by encouraging new investment. With large chunks of the 9000-page Tax Act sent to the mulchers, businesses could apply their energies to generating (taxable) income for shareholders.* If it is possible to convince and old leftie like Toohey of the merits of abolishing company tax, then perhaps there is some cause for optimism on this score. Of course, one could make a similar case in relation to abolishing capital gains tax, but I doubt Toohey would buy into that one. I highly recommend a study by Alan Reynolds commissioned by the Australian Stock Exchange on capital gains taxes. The first chapter on defining capital gains challenges a lot of conventional wisdom on this issue.

posted on 2/28/2004

The IMF and Japan.

IMF MD Horst Koehler has been visiting Japan. Rather than throwing the book at Japan over its attempt at running a de facto fixed exchange rate regime through massive intervention in foreign exchange markets, Koehler has endorsed Japan's actions: *"I do think it was an appropriate policy stance," IMF Managing Director Horst Koehler told a press conference after wrapping up two days of talks with Japanese officials....Koehler said his talks with Prime Minister Junichiro Koizumi and other officials had convinced him that intervention has been aimed primarily at slowing the pace of domestic price falls and bolstering Japan's weak financial system. "I do not think ... that the objective of these interventions has been to boost exports," he said. "It was an option taken because of the limited number of other options to avoid spiraling deflation and secure the integrity of the financial system here - and it worked." With Japanese interest rates already at virtually zero and fiscal policy constrained by ballooning deficits, battling price falls through foreign exchange policy was "a practical step," he said. His comments are likely to embolden Japan's Finance Ministry to continue to cap the yen's rise, despite complaints from Europe and elsewhere that the policy has forced the euro and other currencies higher, as they absorb a larger share of the dollar's broad-based decline. Koehler said he supported the Bank of Japan's "increasingly proactive approach" to monetary policy under Fukui, who was appointed to head the central bank last year.* As discussed in previous posts, there is no reason to expect unsterilised foreign exchange market intervention to translate into a substantively easier monetary policy stance in the current environment and there has been almost no substantive change in Japanese monetary policy since March 2001. The fact that the IMF MD has bought into these views suggests not only a very limited understanding of the political economy of Japanese monetary and exchange rate policy, but a lack of commitment to the IMF's own foundational principles. Meanwhile, James Dorn argues that liberalisation of cross-border capital flows is important for human rights in China.

posted on 2/26/2004

Andrew Stoler,

executive director of the Institute for International Business, Economics and Law at the University of Adelaide and former deputy director-general of the World Trade Organisation, on the Australia-US FTA: *Having just concluded FTAs with Singapore and Thailand, and embarked on the study of an FTA with China, is there really any reason to think that Australia would be punished because it negotiated the AUSFTA? Just recently, an Indonesian minister, hearing of the FTA results, suggested that his country might be next in line for an agreement with Australia. China appears to be serious about an FTA with Australia. Many speculate that Beijing sees it as a testbed for other bilateral deals, including one with the US. The idea that the AUSFTA has distracted Australia from the Doha round, and that this is why the round is in trouble, is almost too silly an argument to consider. I have spent most of my adult life in Geneva, and I can confidently say that anyone trying to use what happened in the AUSFTA on sugar as an indication that Australia and the US are willing to settle for no meaningful results on agriculture at the World Trade Organisation is someone who purposefully, or through ignorance, projects a misunderstanding of Australia's position in Geneva... Far from being left out of the deal, most Australian agricultural sectors should do quite well under the*

AUSFTA. Far too many people are quick to forget that in this modern Australian economy, nearly three-quarters of people work in the services sector where the AUSFTA clearly promises more competition and cost savings in Australia, and enhanced access for services exporters to the US.

posted on 2/25/2004

Leaked policy research on behalf of the Australian Labor Party
shows that it wants to cut income taxes by $10bn, funded by...oh, wait, *raising other taxes*.

posted on 2/25/2004

Changing foreign aid practices.
According to Marginal Revolution, the US is overhauling its foreign aid spending, including disintermediating international financial institutions and linking aid to measures of the rule of law and trade policy liberalisation. A similar trend is evident in Australia's foreign aid programs. There has been a stronger emphasis on linking aid to improvements in governance, particularly in the South Pacific, where foreign aid largely underwrites poor governance practices. There is a growing realisation that foreign aid suffers from many of the same problems as domestic welfare programs. It is also interesting that among the opposition Australian Labor Party's policy initiatives is withdrawal from the European Bank for Reconstruction and Development, perhaps the most notorious of the multilateral development banks. There is a fairly transparent political motivation to this that Australian readers will understand, but it is still good policy. One of the few advantages flowing from the politically inviolate status of the Australian federal budget surplus is that it is forcing the ALP to think more carefully about spending priorities while still in opposition. Lynne Kiesling also reports on a recent talk by Hernando de Soto.

posted on 2/24/2004

Japan's Recovery.
This blog has often been critical of *The Economist's* coverage of Japanese monetary policy. Its latest leader on the subject argues that 'the best case for optimism that this time the recovery will last is that the Bank of Japan's monetary policy has now become steadily and credibly expansionary.' This is nonsense. *The Economist* confuses a change in style, associated with the change in the Governorship of the BoJ a year ago, with a change in substance. *The Economist* credits Governor Fukui with having 'printed a lot more money,' failing to sterilise the proceeds from foreign exchange market intervention and with rhetoric more strongly geared to promoting positive inflation expectations. In fact, all of these initiatives were well established features of monetary policy under former Governor Hayami, whom *The Economist* calls 'quite possibly the world's worst central banker.' It is certainly true that Governor Fukui has made greater use of some of these policy tools, but almost no one apart from *The Economist* believes that these amount to a substantive change in policy. As even orthodox monetarists like Robert Hetzel and base money growth-rule advocates like Bennett McCallum would argue, there is no reason to expect increased monetary expansion to translate into stronger growth in nominal income or broader money and credit aggregates given the current monetary policy framework and zero interest rate environment in Japan. The BoJ's switch to a quantitative approach to monetary policy in March 2001 under Governor Hayami was undertaken precisely so that the BoJ could appear to be taking policy action, knowing full

well that these measures did not amount to much in substance. The fact that Japan is now enjoying another cyclical upswing, with no substantive change in monetary policy since March 2001, is itself a strong argument against the view that monetary policy has been a decisive factor in holding back Japan. Japan has likely seen a permanent reduction in its trend growth rate associated with real factors. Monetary policy is largely irrelevant to this process. Most of the domestic pressure on the BoJ to adopt a more aggressive approach to monetary easing over the years has come from old-line LDP politicians and bureaucrats, the so-called 'techno-rivalists,' who see macroeconomic stimulus as a way of avoiding the demands of structural reform. They have a firm friend in *The Economist*.

posted on 2/20/2004

Nicholas Eberstadt

reviews demographic trends in Asia, part of a wider project in which he looks at the implications of 'unfolding demographic forces on the balance of international power.' The data reviewed by Eberstadt is certainly interesting, but I am note sure that it really tells us very much about the future balance of international power. Indeed, Eberstadt is very careful not to read too much into the data he examines or to speculate about its broader implications. This is just as well, because from an economic point of view, it is not clear that demographic trends by themselves tell us very much. A great deal depends on how these trends translate into labour force utilisation and on labour productivity. The exogenous growth literature is full of 'growth miracles' and 'growth disasters' that are really only explicable in terms of institutional differences between countries. Eberstadt suggests that demography in general, and immigration in particular, has been important to US strategic pre-eminence. I suspect that this is really just a sub-set of its general openness and its adoption of political institutions conducive to that openness. The good news is that prospective demographic trends 'contribute to the calculus of US strategic pre-eminence.' US pre-eminence is largely a function of the classical liberal ideas that are the foundation of its institutions. People are attracted to institutional arrangements that work, while competing institutional forms have proven notoriously lethal to their often captive populations. There is a selection bias at work here. Eberstadt is overly sanguine on Japan, pointing to what is probably a best case scenario: *Today's writing on the negative effects of population aging in Japan focuses (sometimes to near exclusion of all other factors) on public finances and quite rightly points out the actuarially unviable state of the country's national pension system and the looming liabilities for its public health care sector. There is no concrete commandment, though, that a country must leave parlous budgetary imbalances uncorrected. Painful though such exertions would surely be, it is entirely within the purview of the Japanese policymakers and voters to set the country's pension and health systems on a financially secure course. (Sure enough, OECD calculations suggest that a number of relatively obvious changes could significantly improve the financial health of the national Japanese pension system.)* Eberstadt essentially glosses over the political economy of reform in Japan. Buried in the IMF's work on public sector debt stabilisation in Japan are convenient analytical devices, such as an increase in consumption taxes to 25%. My own modeling of the Japanese economy suggests that the short-run output cost of the 1997 consumption and income tax increase was similar to that of the Great Hanshin Earthquake. Fiscal consolidation is much easier said than done.

posted on 2/19/2004

The Centre for Independent Studies

is running its Liberty & Society Seminars again this year. Having attended both the IHS version in the US and the CIS version in Australia, I can say that both are a rewarding experience for students. Here is what the CIS has to say about the seminars: *Liberty and Society is for young people who may be questioning the standard answers they are getting regarding social, political and economic issues. You may not see yourself as a fitting into the 'left' or 'right' mould. This is an opportunity to consider the classical liberal perspective. Classical liberalism promotes individual freedom, private property, limited government and free trade. Join us for an intellectual experience that may change the way you think about the world.*

posted on 2/19/2004

RBA Deputy Governor Glenn Stevens

invokes Wicksell's idea of the natural rate of interest in explaining the RBA's approach to inflation targeting. There has been renewed interest in the idea of a natural rate and its role in monetary policy in recent years. This reflects the fact that monetary policy rules frequently assume or imply some neutral interest rate, usually taken to be some long-term average or fitted constant. The implications of these assumptions about a neutral rate are receiving increased attention, leading to a re-examination of Wicksell, among others. Michael Woodford has produced a new work in monetary theory that is being widely hailed as the successor to Don Patinkin's classic work and which sets out what he calls a neo-Wicksellian approach to monetary theory. For those interested in Swedish and Austrian School approaches to monetary theory, I would highly recommend Steven Horwitz's *Microfoundations and Macroeconomics: An Austrian Perspective*.

posted on 2/18/2004

Peter Ruehl

subjects a certain issue to the soccer mum scratch test: *It's also interesting to hear what does or doesn't come up when you're not around politicians, other journalists or booze. And the one thing that didn't come up the other day was John Howard's backflip on politicians' pensions. I heard about Sydney's trains, which, in the interests of efficiency, are now about to switch over to a mule-drawn system. And I heard about housing prices, interest rates, school discipline and the weather. The general gist was that something was wrong about everything. Then I got home, opened up the usual collection of Saturday papers and got hit by this barfstorm of how Mark Latham had transformed the political landscape, with at least one suggestion that Howard couldn't possibly win the next election. Look, I'm all in favour of Latham making a contest out of this, and at this point it doesn't jerk my chain whether he becomes prime minister or not, but this seemed like the biggest rush to judgment since eight-track cassettes.* I think this goes to the broader point that what is seen as important by the parliamentary press gallery is often of almost no importance to anyone else. It is interesting how first hand experience is often wildly at odds with media-constructed conventional wisdom. It is easy to dismiss such experience as anecdotal. Yet few journalists rise above the anecdotal themselves and often draw on a very narrow range of direct experience. The disintermediating role of the blogosphere in relation to traditional media has a lot to do with its ability to access this distributed knowledge and experience.

posted on 2/17/2004

Fiscal fine-tuning is making an intellectual come back in the UK
in response to the demands of euro convergence, according to Samuel Brittan. Brittan argues that this is an argument against euro membership. Although I share his opposition to UK euro membership, I am less troubled by the suggestion that fiscal policy should be required to adhere to a counter-cyclical policy rule. Such a rule implies a reduction in the discretion of the fiscal authority and is thus somewhat different from the activist fiscal policies of the past that Brittan rightly argues we should avoid. I suspect Sam would argue that the operation of any such rule would suffer from severe Hayekian 'knowledge problems,' such as the difficulty of estimating latent variables like the output gap, making the application of the rule inherently discretionary. These problems would, of course, argue against almost any discretionary counter-cyclical response from macro economic policy. But a fiscal policy rule might still be useful in making macroeconomic policy more predictable and less destabilising, a very different proposition from the discredited fiscal policy activism of previous decades. It is encouraging that the Australian Labor Party's long period in opposition at a federal level has promoted a renewed interest in fiscal policy rules and central bank reform. My expectation is that if there is a change of government in Australia later this year, we are likely to see a substantial overhaul of the institutional framework for macroeconomic policy in Australia. That would be a change for the better.

posted on 2/16/2004

Daniel Gross
has a reasonable layman's discussion of the limits to US exchange rate policy in *Slate*. Gross is rather too generous to former Treasury Secretary Rubin, recycling the conventional wisdom that his Wall Street background made him a more skilled Treasury Secretary. Unfortunately, it also made the Treasury an easy target for regulatory capture by Wall Street, particularly institutional bond holders. The Bush Administration's practice of appointing old-line industrialists to the position has been positive in this regard, although we have seen fewer serious financial crises that would really test whether the Administration would hold the line on these issues better than its predecessor. Interestingly enough, those who predicted that O'Neill would take a mercantilist approach to exchange rate policy because of his industrial background were dead wrong. Both O'Neill and Snow have favoured a non-interventionist policy stance. See this article for an excellent discussion of the 'myth of a strong dollar policy.'

posted on 2/14/2004

World Bank President Jim Wolfensohn

is beginning to compete with George Soros in terms of loopiness. Wolfensohn has been visiting his native Australia, where he has been making much of the fact that world spending on defence greatly exceeds that on 'development.' It is easy to raise a cheer on this score, but it is a view that assumes that all spending on 'development' comes from the official sector. The main driver of economic growth in the developing world is private capital markets and not official development assistance. Indeed, as the late Lord Bauer argued so persuasively, much official sector development assistance hinders rather than assists growth. The World Bank's lending is notoriously ineffective, even by its own standards. This is characteristic of the lending of other official sector international financial institutions. See Graham Hancock's *The Lords of Poverty: The Power, Prestige, and Corruption of the International Aid Business* for a what remains a very relevant critique of the IFIs. Few of the world's developed democracies spend money on defence cheerfully. But even if we could downscale military spending, reallocating those funds to official development assistance would be a bad idea. This is something best left to private capital markets. Wolfensohn's simplistic homilies are not doing anyone any favours.

posted on 2/13/2004

William Shawcross

is not an author I would normally identify with, but this review of his book on the Iraq war suggests that he shares my own perspective: *The issue of weapons of mass destruction was not, as he explains, a simple one of whether they existed or whether they were primed for immediate attack on western countries. The real issue was whether it would have been right to take the risk that Saddam had them, might use them, or might resume development of them as soon as the coast was clear. All the evidence collected by UN weapons inspectors in 1991-98, when they were allowed in Iraq, pointed to the conclusion that Saddam could not be trusted. The inspectors themselves believed at that time that large caches of weapons materials remained to be found. Meanwhile the containment operation, a combination of no-fly-zones, bombings and UN sanctions, was producing misery and grievances without making Saddam feel any more trustworthy. He and his regime remained a source of strategic instability in the whole Middle East, a mortal danger to his own people and a plausible sponsor of terrorism. There were no good options available, but leaving things as they were looked the worst of all.* Along with Christopher Hitchens, Shawcross is one of the few members of what I would call the realist left. After the Krugman cover episode, I was not entirely surprised that the jacket cover of Hitchens' short book on the war gives almost no hint that he actually supported it. Evidently, the publishers thought this might be bad for sales, yet I would have thought that his distinctive point of view was the main selling point. At the same time, *The Economist* reviews George Soros' latest book in two words: 'get real.'

posted on 2/12/2004

Some of my former colleagues have a new web site,
G7Forex, devoted to technical analysis of foreign exchange markets. Having worked alongside the principals, I can vouch for their skills as market technicians and I was often impressed with their insights. If you have an interest in foreign exchange markets, I recommend you take a look at their site. You might wonder why an advocate of the efficient market hypothesis would endorse a site devoted to technical analysis. Technical analysis is frequently misunderstood. In at least one important respect, it makes the same assumption as the EMH: price discounts everything. Technical analysis differs, however, in arguing that prices nonetheless contain exploitable information about the balance of supply and demand. There have been quite a few studies showing that simple technical trading rules can generate excess returns over a buy and hold strategy. Usually, these studies are taken to be indicative of some unknown informational inefficiency. This is not unique to technical analysis. Some fundamental indicators have also been shown to generate excess returns (the Australian dollar TWI against the terms of trade, for example). Foreign exchange markets get a particularly bad press for their supposed failure to adhere to fundamentals. The fact that these markets are notoriously difficult to model and forecast econometrically probably reflects the fact that market participants draw on a much larger information set than is available to the econometrician. Moreover, there are some well established economic models that explain phenomena such as exchange rate 'overshooting.' Those who dismiss foreign exchange markets as being irrational usually do so because the market has failed to conform with their own prejudices about fundamentals. As behavioural finance research suggests, people are typically very reluctant to accept they have been wrong. The idea that everyone else is irrational is subjectively much more appealing. Another of my former colleagues has a book out on *Currency Strategy*.

posted on 2/11/2004

A US perspective
on the exclusion of sugar from the Australia-US FTA, from the Cato Institute.

posted on 2/11/2004

Ross Garnaut
decries the Australia-US FTA in predictable and unconvincing terms. Garnaut argues correctly that: *The majority of the gains in the study for DFAT come from Australia's own reduction of barriers to American exports. We could have these gains, and much more, without the costs [?] of an FTA, by liberalising imports from all countries, in a continuation of the unilateral liberalisation that was a feature of Australian trade policy from the mid-1980s to 2000.* But this is not an argument against the FTA. Unfortunately, as Garnaut should appreciate, unilateral trade liberalisation is not going anywhere. Domestic protectionist interests have brought this process to a near halt in Australia as well as in the US. By negotiating an FTA, both Australia and the US gain leverage over these domestic interests. Governments have resorted to bilateral agreements precisely because unilateral and multilateral trade liberalisation processes have stalled. It is a way of making progress that would not otherwise be possible. Alan Mitchell, who at least appreciates the classical case for free trade, is running the shop-worn line that 'by embracing a discriminatory trade deal with the US, we seemed to vindicate those Asian politicians who have worked for our exclusion.' Given Australia's recent

successes in concluding FTAs within the region, this argument is looking increasingly shaky. By all accounts, China's interest in pursuing a FTA with Australia is a direct outcome of the US-Australia negotiations.

posted on 2/10/2004

The Australia-US Free Trade Agreement

looks like a done deal. Unfortunately, analysis of the agreement will be conducted in the usual zero-sum framework, with critics bemoaning Australia's failure to gain better access to US markets for certain agricultural products. John Quiggin calls the agreement 'unbalanced,' an 'election-loser' and cites a 'list of wins' that fails to mention improved US access to Australian markets, which is how Australia really stands to benefit from the agreement. Even if the agreement had been completely 'one-sided,' with Australia making all the concessions, we would still be better-off. **UPDATE:** Peter Gallagher and Sarah Strasser have preliminary takes on the detail of the agreement. My own concerns relate to the failure to more fully liberalise cross-border direct investment in Australia and the preservation of local content rules for media. It is good to see Australia's arts community can compete with US farmers in terms of self-interested parochialism!

posted on 2/9/2004

'International political economy'

is a sub-discipline of international relations, in which I took some interest as an undergraduate, since I was completing an honours degree in political science, as well as majoring in economics. At the time, I was struck by how ignorant many of the scholars in the IPE field were of economics. For the most part, they were only interested in superficial caricatures of economic ideas. Reading Dick Bryan's review of Robert Gilpin's *Global Political Economy* in the most recent *Economic Record*, I see that little has changed. Gilpin is a leading scholar in IPE, yet as Bryan notes, he 'too often finishes up ignoring the subtle issues that cause deep debates within disciplines…Readers may well see theories whose detail and precision they value rather trivialised and caricatured in this treatment…I find this book frustrating for the way it breezes through issues I believe need far more subtle interpretation.' This is a great shame, because economics has the potential to greatly augment the IR discipline, which is notoriously reliant on ad hoc theorising. This is probably an opportune time to mention Aurelia George Mulgan's *Japan's Failed Revolution*. Mulgan is a political scientist who draws on the work of economists writing about economic crises to explain contemporary Japan. Although she does not say as much, I read her book as an implicit admission that the political science discipline could not explain contemporary Japan. Indeed, I have noticed a number of Japan scholars fighting fierce rearguard actions against the encroachment of rational choice theory on their discipline.

posted on 2/6/2004

Media reporting of foreign exchange market intervention by the Bank of Japan is often inaccurate,
according to an article comparing media reports to actual intervention data for the period 1995 to 1999 (Frenkel et al (2004) *Journal of International Financial Markets, Institutions and Money*, 14:25-36). The authors find that the probability of an intervention report being accurate is only 60%. The probability of an intervention report appearing in the press given that intervention actually occurred is only 45%. The majority of the interventions conducted by the BoJ were not reported in the press, while the press frequently report intervention that never takes place. I think this partly reflects on the nature of financial market journalism. Journalists are required to report on markets on a daily basis, regardless of whether there is an interesting story to tell. They are also called upon to account for market moves for which there may be no obvious explanation. Reporting market intervention rumours is an obvious way to fill the page and explain market moves that cannot be rationalised otherwise.

posted on 2/5/2004

The Alice Springs to Darwin railway
has seen its first passenger journey, to much fanfare and overblown rhetoric. This was a project conceived in the 19th century and the 19th century is probably where it should have remained. As Australia's leading transport entrepreneur, Chris Corrigan, has so delicately put it, the returns on the project (heavily subsidised by state and Federal governments) are probably 'smaller than a flea's testicles.' Perhaps the most disturbing aspect of the project is its demonstration of the extent to which politicians and the public remain wedded to 19th century technology and thinking. Trains are all very romantic, but the romance comes from the fact that these are essentially relics of the early industrial age. What would have been an impressive achievement in the late 19th century is far from being remarkable in the 21st. The rhetoric of 'nation-building' that frequently accompanies such projects would probably not wash in any other developed country and even in Australia is often just a cynical cloak for a boondoggle. Australia's public imagination needs an overhaul.

posted on 2/4/2004

Richard Clarida
argues against further rhetorical innovation in relation to exchange rates on the part of the G7 at its upcoming meeting in Boca. As Clarida notes, official rhetoric on foreign exchange rates is often destabilising in itself and he argues for the G7 to stick to the formulation in the Dubai communiqué for the sake of stability. G3 macro policy coordination and joint foreign exchange market intervention has a sorry history. Perhaps the best thing the G7 could do for the sake of global macro stability would be to forswear future attempts at macro policy coordination and joint foreign exchange market intervention. A joint commitment to a non-interventionist policy stance from the G7 would remove an important source of uncertainty from financial markets and help insulate monetary and exchange rate policy from political pressures associated with current account imbalances.

posted on 2/3/2004