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Capitalist Internationale? The WSJ's Bret Stevens reports from the WEF meeting in Davos:

At an Internet café late Thursday night, I am set upon by two Swiss undergrads who earlier in the day had participated in an antiglobalization rally. How, they would like to know, do I justify my presence at this malign gathering of the Capitalist Internationale? O that it were the Capitalist Internationale, I reply. I explain that this year's Davos is purpose-built to satisfy all of their grievances. They think the Forum's concern for the poor and the environment is a meaningless gesture at best and probably a devious trick. I think: "The capitalists will sell the rope from which they will hang."

(Thanks to John Rogers for the pointer).

posted on 1/2/2005

The World Economic Forum. I have never been a fan of the WEF, although its demonisation by the anti-globalisation left is an endless source of amusement. Gatherings of the great and the good rarely produce anything worthwhile. This year's Forum seems to have taken a turn for the worse, with the participation of celebrities such as Sharon Stone, Bono and Angelina Jolie, among others. The discussions on poverty have provided plenty of opportunities for conspicuous compassion, yet many of these debates are pointless because they are blind to the fundamental causes of poverty. Reducing poverty is not about rich countries spending money on poverty alleviation. Indeed, by all accounts, such spending makes poverty worse by institutionalising statism and corruption in developing countries. Reducing poverty requires promoting the necessary conditions for wealth creation: property rights, free markets and the rule of law. Unfortunately, these are rather abstract concepts, difficult to translate into practical programs and well beyond the attention span of your average celebrity.

Adam Smithee has been casting a sceptical eye over the WEF proceedings and is well worth a visit.

posted on 30/1/2005

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Fallen and I Can't Get Up: Is the U.S. Dollar About to Crash ... Again? Learn More.

Australia Day, 2005. After 217 years, this outpost of the Anglosphere is probably in better shape than it has ever been. The economy has been growing at one of the fastest average rates in the OECD over the last decade, the unemployment rate is at near 30 year lows, real investment as a share of GDP is at the highest levels in nearly half a century and net Commonwealth public sector debt has been all but eliminated. Consumption growth and a widening current account deficit, far from being a sign of weakness, indicate confidence in Australia's future growth prospects. Perhaps less widely known is the fact that Australia has become a net exporter of direct investment capital in recent years. At least some of Australia's current account deficit is thus funding the globalisation of Australian business.

Against this backdrop, the Prime Minister's approval rating is at its highest levels ever. This is not unrelated to the fact that the federal opposition Labor Party is in disarray following its crushing election defeat last year. The abandonment of foreign and defence policy bipartisanship under former Labor leaders Crean and Latham is at least partly responsible for this outcome.

Having said all that, Australia still has much unrealised potential. With the anti-globalisation bloc in the Senate having been marginalised following the last federal election, there is little excuse for not completing the task of modernisation and integration with the global economy begun in the early 1980s. 2005 is likely to go down in history as the year in which this historic opportunity to finally bury isolationism, protectionism and paternalism was either seized or squandered.

posted on 26/1/2005

Pop Austrianism and the Business Cycle. Austrian economics has always had an uneasy relationship with macroeconomics. Contrary to widespread belief, Austrian economics is not completely antithetical to macroeconomics and Austrian economists have developed some distinctive macroeconomic ideas. This is especially the case in relation to the role of money in the business cycle. Unlike the dominant Walrasian general equilibrium paradigm, Austrian economics takes money seriously and gives it a central role in business cycle dynamics.

Unfortunately, a rather stylised version of Austrian theories of the business cycle has taken hold. This pop Austrianism insists on interpreting every fluctuation in the business cycle as reflecting some failure of monetary policy, which in turn drives changes in relative prices, a process of resource misallocation and asset price inflation/deflation.

This stylised account often results in macro commentary that completely ignores the many other influences on the business cycle that are non-monetary in origin. This resort to monocausal explanation saves pop Austrians from taking other sources of business cycle fluctuations seriously and assists them in promoting their various hard money doctrines at the expense of a serious examination of existing monetary institutions.

This stylised account is actually rather contrary to the spirit of Austrian economics, which argues for disequilibrium as an essential part of market processes, even without the benefit of monetary policy mistakes. If we are to take Austrian monetary economics seriously, then almost any discretionary fiat monetary regime will by definition result in continuous monetary policy errors. The question is how important these errors are to macro outcomes. This is an empirical question that pop Austrians are loath to examine seriously. The meta level criticisms of contemporary monetary policy regimes are important, but few pop Austrians take dynamics within existing monetary regimes at all seriously.

Many pop Austrians consequently become unduly suspicious of growth in credit and other financial aggregates and asset prices, interpreting them through the prism of monetary policy error and failing to take account of the importance of innovations in financial technology and preferences that might account for them. This makes pop Austrians unwitting allies of those who argue for interventions in capitalist acts between consenting adults. Pop Austrians often resort to the same empty talk about 'bubbles' usually employed by those who think they know better than markets what financial and other macro outcomes should look like.

I have refrained from linking to specific sources for these views, since they are sadly all too common and it would be unfair to single out any one source. But they are seriously at odds with the tradition they claim to represent.

posted on 24/1/2005

Testing Conspicuous Compassion. The Indian Ocean tsunami has provided plenty of opportunities for conspicuous compassion. Will Wilkinson proposes that the best way to help tsunami affected countries would be to allow their people to work in the US and urges Congress to pass President Bush's temporary worker plan. This argument can be generalised to include countries like Australia. Yet I suspect that this proposal would be rejected by many of those who were otherwise generous contributors to tsunami relief. Compassion often falls short when it comes to supporting free trade in human capital.

posted on 20/1/2005

Was Mark Latham Really an Ideas Man? If political success is the only relevant measure of the man, then Latham could be fairly described as 'the most incompetent and dangerous' Labor leader since his mentor, E G Whitlam. Some of his supporters are spinning his demise thus:

Latham's achilles heel was his excessively academic outlook on the world.

There is a danger that Latham's reputation as an ideas man will serve to discourage those that seek to bring fresh ideas to politics. Yet Latham showed only limited range to his ideas and little capacity to systematise them or develop coherent policy. His prospective replacement, Kim Beazley, is arguably more of a scholar (and has even held a minor academic post), yet few people highlight this as a key Beazley strength. The same could be said of Bob Carr. What this suggests to me is that the emphasis on Latham as a supposed ideas man was an attempt to paper over his many other deficiencies. Like former Labor Prime Minister Paul Keating, there was a significant element of overcompensation in Latham's intellectual interests.

As Andrew Norton suggests, the sources of Latham's demise can indeed be found in academic textbooks, but not in the way his supporters would like to think! Latham should have spent more time reading books than writing them.

posted on 19/1/2005

The RBA and Capitalist Acts Between Consenting Adults. The RBA has commissioned Roy Morgan to conduct a comprehensive survey of household attitudes in relation to housing equity. This is a welcome development, since it promises to bring some hard data to the discussion of policy issues that have for the most part been dominated by anecdote and silly prejudice. My guess is that the survey will reveal that tax minimisation and consumption smoothing have been among the factors motivating households to take advantage of innovative home equity lending products.

More importantly, the survey is likely to expose the massive disconnect between actual household behaviour and the related national accounting concepts. John Edwards has noted that Australia’s negative household saving ratio is a function of the notional amount the ABS deducts for depreciation of the housing stock, which has increased substantially in recent years. Needless to say, this is far removed from the way in which households think about home equity and their own saving behaviour.

Edwards has also made the important point that national saving as a share of GDP has barely moved in recent years. Australia’s growing current account deficit is a function of the fact that the investment share of GDP in real terms is at its highest levels in at least half a century! Only a fraction of this is attributable to dwelling investment. Consumption, by contrast, remains perfectly steady as a share of GDP. The widely held notion that Australia is dangerously consuming its way into foreign hock by way of raiding home equity is a complete nonsense.

posted on 15/1/2005

The Centre for Independent Studies is recruiting for its Liberty & Society program for 2005, as well as calling for entries for the Ross Parish Essay Prize. As a graduate of both the CIS and IHS Liberty & Society programs, I can highly recommend the experience to prospective applicants.

posted on 15/1/2005

Unemployment as Policy Choice. The further fall in the unemployment rate in December to 5.1%, the lowest since late 1976, should not come as a big surprise to those who have noticed the proliferation of help wanted signs in shop windows throughout Australia’s capital cities. While a good result in absolute terms, it is still a poor number in comparative terms. New Zealand’s unemployment rate is also at record lows (in terms of the current series) at 3.8%. Given that both economies are in similar positions in terms of their business cycles, this suggests that over one percentage point of Australia’s unemployment rate is attributable to Australia’s less flexible labour market institutions. In other words, Australian policymakers have chosen to live with an unemployment rate more than one percentage point higher than it needs to be.

Australia’s unemployment rate is still only marginally below the US rate of 5.4%. It took a recession in the US and a boom in Australia for unemployment rates in the two countries to converge. Australia’s unemployment rate is an international embarrassment.

This highlights the importance of further industrial relations reform, which has now become possible with government control of the Senate. Whether the current government can deliver remains to be seen. Its previous reforms were not exactly inspiring, even making allowance for obstructionism by the opposition and minor parties in the Senate.

posted on 13/1/2005

Tom Wolfe's Latest. *I Am Charlotte Simmons* is written in characteristic Wolfe style and explores themes common (perhaps a little too common) to his earlier novels. Some of the material is anticipated in his non-fiction collection, *Hooking Up*. There is much to recommend his portrayal of contemporary undergraduate life, although I am not sure this differs fundamentally from my own undergraduate experience in the 1980s. There are only a few minor lapses that escaped the editorial oversight of Wolfe's college age children (the investment bank with the .org email address, for example). My only disappointment with *IACS* is that Wolfe doesn't take the opportunity to explore larger themes in relation to universities and their place within society. Wolfe ultimately lets universities off far too lightly. Perhaps they are too easy a target. The story could have benefited from a larger context.

As with *A Man in Full*, there are some strained plot elements, not least the idea of a state governor getting an al fresco blow job from an undergraduate (surely they would get a room!) and the Nobel Prize winner not only marking an undergraduate paper, but calling the student in to discuss it. Charlotte's character does not always convince, although Wolfe's portrayal of depression will be distressingly familiar to those who, life Wolfe, have experienced the condition themselves or have seen it in others.

The Bad Sex Award Wolfe received for *IACS* misses the point: the sex is meant to be bad, and is written accordingly. There are some nice digs at sociology, as well as the vacuity of management consulting, the latter being set alongside the discussion of the 'Bad Ass Rhodie.' I'm not sure if it was Wolfe's intention to equate the two, but given the well deserved reputation of Rhodes Scholars and management consultants for being empty vessels, the juxtaposition is entirely apt.

IACS is not Wolfe at this best, but is rewarding nonetheless.

posted on 12/1/2005

Prediction Markets in 2004. The Chris F. Masse 2004 Year-End Awards provide a great round-up of scholarly and business-related developments in the area of prediction markets, as well as being highly entertaining in their own right. My favourite category:

Best Comeback: *The Yasser Arafat Termination contract on InTrade.*

posted on 10/1/2005

Season's Greetings. As usual, blogging will be light at best over the Christmas-New Year period. Let me take this opportunity to thank IE readers and affiliates for their support throughout the year.

In the New Year, I plan on rolling out a new blog, adding a number of features that readers have been pestering me for. So keep watching this space.

posted on 23/12/2004

Shorting the Housing 'Bubble.' Those who think housing is in a 'bubble' now have the opportunity to put their money where their mouth is:

Macro Securities Research, a company affiliated with Robert J. Shiller, the Yale economist, has reached an agreement with the Chicago Mercantile Exchange to list pairs of derivative instruments that are essentially index funds linked to home prices in certain markets. One instrument in each pair will rise as its market index rises; the other will rise as the same index falls. That will let investors bet on the direction of housing prices.

This will be an interesting test of Shiller's ideas, in particular, whether there is a market for financial instruments that allow individuals to diversify a much broader range of personal risks than more conventional financial instruments would otherwise permit.

Perhaps a more accurate way of benchmarking the performance of economists would be to require them to run portfolios in financial derivatives and prediction markets linked to economic outcomes. This could yield a more meaningful measure of forecasting performance than measures such as mean absolute forecast error, not least by allowing economists to place much larger bets on outcomes about which they feel more confident.

posted on 22/12/2004

More US Dollar Hysteria. Barry Eichengreen argues that 'The optimists who are welcoming the dollar's fall should think again.' Eichengreen would have us believe that not only a US, but a global recession is the inevitable consequence of the USD's decline. Eichengreen relies on the same tired old argument that as the USD falls, foreigners will not fund the US current account deficit, inflation and interest rates will rise, tanking the US and world economy

There are numerous problems with this view. The current account must be financed by definition, so if foreigners are reducing their funding of the current account deficit, this implies that the deficit must be narrowing anyway, which in turn puts a floor under the USD's decline. Even if interest rates do rise, this will slow the economy and narrow the deficit also. A slowing economy will very quickly see interest rates fall rather than rise, since domestic interest rates are much more sensitive to domestic economic conditions than to exchange rates. Expected interest rate differentials have a much bigger impact on exchange rates than exchange rates have on interest rates. Rising US interest rates would again put a floor under the USD. For a large, relatively closed economy, with plenty of slack like the US, a falling dollar will not put much pressure on inflation either.

What makes Barry's op-ed especially disappointing is that he is the author of a good book on the contribution of the gold standard to the Great Depression. Yet Asia's managed exchange rate regimes don't rate a mention in his op-ed - it's all a US problem.

The world economy could well be headed for a recession, but the decline in the USD is not the causal mechanism: it is merely symptomatic of the monetary train wreck unfolding in East Asia. If the US suffers, it will only be because the implicit subsidy to US and world growth from forced saving in East Asia might end. Yet even that is doubtful, because recession in East Asia means even more surplus industrial capacity needs to be offloaded onto world markets. The problem is not that the US has saved too little, but that East Asia has saved too much as a result of the state sponsored mercantilism that is the fundamental cause of global imbalances.

posted on 20/12/2004

The AEI Disappoints Once Again. You might think the American Enterprise Institute would have some faith in market-determined exchange rates, rather than calling for interventionist policies by the IMF and US Treasury. You would be wrong. According to Desmond Lachman:

International leadership is woefully lacking in dealing with the vexing problem of the U.S. dollar's chronic weakness. In the absence of effective leadership by either the U.S. Treasury or the International Monetary Fund, there is every prospect that the dollar's recent steady decline will soon turn into a rout. That could have very untoward consequences for global financial markets. And as painful experience has shown, turbulent market conditions can be destructive of international economic prosperity.

Actually, experience suggests the very opposite. Real economic activity is remarkably resilient to exchange rate volatility, especially in those countries with flexible exchange rate regimes, where economic agents learn to effectively manage the associated risks. The story is very different in countries with fixed exchange rate regimes, but that is a problem for them, not the US. The most effective solution to the distortions governments routinely introduce into global trade in goods, services and capital is in fact market-determined exchange rates, since they can adjust to offset many of these distortions. Countries only get into trouble when they fight this adjustment process.

The 'liberal' (in the American sense of the term) Institute of International Economics evinces much more faith in market outcomes and the resilience of the US economy than does the AEI:

there was unanimous agreement among the participants that further depreciation of the dollar was needed to achieve a sustainable relationship among national currencies and current account positions. The participants also observed that there were two important advantages in achieving this realignment promptly. One was the presence of considerable slack in the US economy, which meant that the dollar could decline without much (if any) adverse impact on US inflation and interest rates. The second was the superiority of US economic performance relative to other industrial countries, which reduced the risk of capital flight from the United States and thus of a disorderly dollar depreciation that could lead to a "hard landing" for the US and world economies.

posted on 18/12/2004

'I used to think, now I read The Economist.' So goes some of the magazine's promotional material around campus. There is both intended and unintended irony in that statement! The current Buttonwood columnist has penned their final column:

That is about all the seasonal good cheer that Buttonwood has to offer, except to say thank you to those many readers who have written, even to those who have disagreed with every word.

You're welcome. Memo to Bill: I can recommend plenty of undergraduates who will produce a better column at half the price.

posted on 17/12/2004

Regulating Prediction Markets. Prediction markets have run into numerous regulatory difficulties, not least as a result of lobbying by incumbent gaming interests seeking protection against competitive threats. Many prediction market operators have been driven offshore to places like Ireland, although this has not stopped their operators from being pursued by the Justice Department. The US has been the subject of an adverse WTO ruling for protectionism in relation to these matters.

An AEI-Brookings Joint Centre paper advocates bringing prediction markets under federal jurisdiction and subjecting them to an 'economic purposes' test. The idea is to distinguish between prediction markets and sportsbetting exchanges, with the latter remaining subject to gaming laws, while the former come under the jurisdiction of the CFTC. The authors' recommend that over-the-counter markets remain free of regulation.

While quarantining prediction markets from gaming regulation is no doubt desirable, the problem here is surely the regulation of gaming in general and the rent-seeking it promotes. I am also suspicious of central government regulatory takeovers, not least because they eliminate the possibilities for regulatory arbitrage between competing jurisdictions at the sub-national level. For example, Australia's Northern Territory has benefited from a more liberal approach to gaming regulation, which has seen it become the home of a number of sportsbetting operations. For its part, the Australian government is notorious for regulating gaming for the benefit of incumbents and has all but killed what could have been a major export industry in the form of cross-border on-line gaming.

posted on 15/12/2004

RBA Deputy Governor Stevens puts the exchange rate risks associated with current account deficits in perspective, highlighting the under appreciated fact that most of these risks are swapped out by financial markets:

But in this case the borrowers' obligations are in Australian dollars, not foreign currency, and the same is true for the intermediaries who funded the loans (and hedged their risk). Foreign suppliers of capital are, in fact, bearing the exchange rate risk. So if there is a problem here, it is not that Australian households borrowed from foreigners, in particular, to fund investment in the dwelling stock, it is that they borrowed from anyone to do so…

It is fairly extreme to assume that there would be a total 'sudden stop' of capital flow, as occurs periodically for some emerging market countries operating under fixed exchange rates that become unsustainable. In all Australia's experience under the floating exchange rate over the past two decades, that has never occurred. Even in the days of greatest concern about the external accounts in the 1980s, substantial capital inflow into Australia continued – the equivalent of between 3 and 6 per cent of our GDP per annum. What did occur, on occasion, was that the cost of foreign capital rose, mainly in the form of a decline in the foreign currency price of Australian assets – i.e. a fall in the exchange rate…

no one can know if such an adjustment will occur, let alone when. But if it did occur, the experience of the past decade suggests we would be able to cope. We have absorbed substantial exchange rate movements, without the economy being derailed. So it seems to me that rather than fretting about the current account deficit per se, it is more sensible to focus on the underlying imbalances in the economy.

posted on 15/12/2004

Our Dollar, East Asia's Problem. Fred Bergsten on the role of China's managed exchange rate regime and the need for revaluation:

China is central to the currency component of the solution because it continues to strengthen its competitiveness by riding the dollar down. This severely truncates the adjustment process because other Asian countries fear losing competitiveness against China and thus block their own appreciations against the dollar. Fortunately, the sizeable appreciation that is needed for international reasons would simultaneously help China cool its overheated economy by damping demand for its exports, countering its alarming inflationary pressures and stopping the inflow of speculative capital that promotes excessive monetary expansion. Beijing can act independently of any foreign pressure by rejecting US and International Monetary Fund entreaties to float its currency and opting instead for a substantial one-shot revaluation.

Bergsten is one of those who see the US current account deficit as being symptomatic of a lack of US domestic saving, rather than forced saving abroad, but he at least recognises the role of managed exchange rate regimes in East Asia as a major driver of these outcomes. Bergsten calls for an aggressive US policy response, both domestically and internationally, partly because he fears a US dollar collapse. Yet it is the market-led decline in the USD that is putting the most pressure on East Asian mercantilism and should be embraced rather than feared. East Asia's managed exchange rate regimes will crack long before a declining USD becomes a problem for the US.

posted on 14/12/2004

East Asian Mercantilism and the US Dollar. Readers have been asking for additional references on this topic. The best book on the subject as it applies to Japan is Akio Mikuni and R. Taggart Murphy's (2002) *Japan's Policy Trap: Dollars, Deflation, and the Crisis of Japanese Finance*, published by Brookings (you can download the first chapter here, which neatly summarises their argument).

Mikuni and Murphy do an excellent job explaining how mercantilism is at the foundation of the modern Japanese state and its role in driving Japan's massive current account surpluses and the resulting excess capacity in the Japanese economy. Japan's enormous holdings of US dollar denominated assets are shown to be a desperate attempt to hold down the value of the yen to sustain this excess industrial capacity, with deflationary implications for the Japanese economy. While I disagree with some of their argument, overall it is an excellent case study in the destructive power of mercantilist ideology. It is also an effective rebuttal of claims by apologists for East Asian mercantilism, such as Morgan Stanley's Andy Xie, that Japanese deflation is the product of yen appreciation.

Some of their argument carries over to China, which relies heavily on the dumping of excess industrial capacity on world markets to bridge the gap in its development strategy while its domestic markets mature. The rest of the world is actually a beneficiary of this process, even if only temporarily, but China ultimately faces many of the same risks as Japan. Japanese policymakers made the mistake of elevating mercantilist goals above all others, sacrificing Japanese living standards through a regime of forced saving closely tied to its management of the exchange rate. China has the opportunity to handle this process differently. A key test will be whether the Chinese authorities will ultimately commit to a floating exchange rate regime and foster market-determined outcomes in relation to domestic saving and investment. The record to date is far from encouraging.

posted on 12/12/2004

More housing 'bubble' skepticism, this time from the New York Fed.

posted on 10/12/2004

An IMF Working Paper on democratic institutions and macroeconomic stability. The growth theory literature has generally struggled to make robust positive connections between democratic institutions and real economic growth. Yet this is perhaps the wrong focus. The authors' focus instead on nominal instability rather than real variables.

posted on 7/12/2004

The Atlasphere. Desperate and dateless Randroids now have their own on-line dating service, including useful advice on 'beauty vs. character, and how to objectively reconcile the two.' Those who have read Jerome Tuccille's libertarian coming of age classic, *It Usually Begins with Ayn Rand*, will not be surprised to learn that the site often descends into self-parodies like this.

Surprisingly, Rand did not make it into the Top 50 of Australia's Most Favourite Book poll run by the ABC. Rand usually does well in pop surveys like this. Maybe the Randians were too busy checking out the talent at the Atlasphere. Indeed, Randians will be outraged to learn that the anti-modernist fantasy *The Lord of the Rings* made it into the number one spot.

UPDATE: Andrew Norton points out that Rand did at least make the Top 100 at 91, edging out savage competition from *Winnie the Pooh*.

posted on 6/12/2004

News Ltd Falls into RBA Trap. News Ltd points to RBA research on interest rates and transparency:

The public release of board minutes by central banks in the US and England has been found to have minimal effect on financial markets, but Australia's Reserve Bank still insists on secrecy due to fears of market "confusion and speculation".

According to a research paper commissioned by the Reserve Bank, releasing information on central bank deliberations has almost no effect on interest rate expectations.

While this is a cute angle, it is also exactly the sort of intellectual trap the RBA wants people to fall into. The RBA has been running a research agenda that not surprisingly plays down the importance of increased transparency and accountability. This is not hard to do, because it is extremely difficult to separate out the effects of institutional differences on economic and market outcomes.

The main arguments in favour of increased transparency and accountability are largely procedural rather than economic. This is the angle News Ltd should be running with. The same article questions leading industry figures on this issue. Australian Industry Group CEO Heather Ridout, in the course of defending the status quo, makes this amazing comment about RBA Board members:

They would always be potentially captive, but their ultimate duty would be to the board.

This recognition that Board members are 'potentially captive' to sectional interests highlights the conflicts of interest that undermine any attempt to improve the transparency and accountability of monetary policy in Australia under the RBA's existing governance framework. The RBA and its defenders are making the less than persuasive argument that they need secrecy to prevent these conflicts coming out into the open. You can imagine the ridicule a private sector board would attract if it made an argument like this in relation to its own governance arrangements. A public sector entity as important as the RBA should be held to even higher standards of corporate governance than the private sector, yet the current Board arrangements are little changed from the class warfare-inspired model of the 1930s.

posted on 3/12/2004

When Bad News Becomes Good. For those who fret about current account deficits, bad news is good news:

That is why the news earlier this week that retail sales have been stuck in first gear since the middle of the year and that home building approvals continue to move lower is actually good news rather than bad.

We need to pull back on our rate of spending growth as a nation, with less consumer spending and home building and renovation. That means most of that belt-tightening needed to be focused among families.

If only the economy would stop growing so damn fast, that nasty current account deficit would go away! I guess Chris Richardson's family will be having a pretty dull Christmas, with all that family belt-tightening.

Meanwhile, Don Boudreaux points to a new source of accounting panic: the blonde current account deficit!

posted on 2/12/2004

Celebrating Two Centuries of Current Account Deficits. The further deterioration in Australia's current account deficit in Q3 to test previous cyclical highs as a share of GDP has seen the usual doom-mongering, with predictions of a currency 'crisis' (the Australian dollar is in fact at historical highs on a trade-weighted basis) and claims foreigners will stop funding our supposedly excessive consumption. The fact that foreigners have been funding Australia's economic growth in this way more or less continuously for 200 years perhaps makes predictions of this kind the single worst cumulative forecasting failure of any economic point of view, yet people never seem to tire of these predictions.

Unlike in the US, the Australia government currently makes a positive contribution to national saving, so the current account deficit is entirely the work of consenting adults. Unless one can make a persuasive case for systemic failure in capital markets, then Australia's current account deficit is an unambiguous sign of economic strength, not weakness. The sad thing is that much of the doom-mongering comes from economists who should know better.

It is also interesting that misplaced fears about current account deficits straddle the left-right divide among economists. In the US, the AEI has generally been disappointing on this issue, although one suspects they are using the current account deficit to gain leverage in debates over US fiscal policy. Desmond Lachman has been talking up the risks of a currency crisis, yet Lachman's commentary makes clear where the real problem lies:

Already some foreign central banks, notably those in India and Russia, are showing clear signs that they are tiring of having to accumulate ever-increasing amounts of depreciating dollar paper. ***They also fear the loss of domestic monetary control and inflationary pressures that flow from having to issue currency to prop up the dollar.*** *It is only a matter of time before other central banks too balk at the potentially large costs to their balance sheets of continuing to pile up dollar holdings in magnitudes that have no historic parallel.*

[emphasis added]

Surely this makes it clear that it is in fact foreign central banks and the economies of East Asia with managed exchange rates that have the sustainability problem. This is also readily apparent in the commentary of Morgan Stanley's Andy Xie, who is one of the main apologists for East Asian mercantilism. Xie has been arguing for the East Asian economies to hold the line on their exchange rates and resist USD depreciation:

The danger for Asia is that it could push the region into the trap of deflation, low growth, and strong currencies. Asian economies are heavy in manufacturing. Strong currencies would cause de-industrialization, which boosts capital surpluses and makes strong currencies even stronger.

Again, it is East Asia that has the problem through its unwillingness to face up to the fact that much of its growth has been purchased via managed exchange rates, which are little more than forced saving schemes that have little relationship with underlying market imperatives. Xie wants the central banks of East Asia to conspire to push up US interest rates, to raise saving and lower consumption in the US, as though US interest rates were set by Asian central banks. Far from having a problem, the US and the rest of the world have been enjoying the benefits of cheap East Asian exports, even if part of these benefits are artificially bestowed by foreign central banks. The real problem is the forced saving inflicted on East Asian economies by managed exchange rate regimes. It is East Asia that has a currency crisis on its hands, one entirely of its own making.

posted on 30/11/2004

Conflicts of Interest and the RBA Board. As mentioned in a previous post (6 November), the RBA is currently before the Administrative Appeals Tribunal in an attempt to prevent Board minutes and voting records being released under an FoI action brought by News Ltd. RBA Governor Macfarlane has now sought to pre-empt the AAT by issuing a conclusive certificate. As *The Australian* notes:

The RBA's conclusive certificate makes any legal attempt to release the documents more difficult as courts can only look at the reasonableness of issuing a certificate and have no power to order its removal...

Mr Macfarlane claims in the conclusive certificate that release of the RBA minutes would reduce the willingness of people to serve on the board.

He also claims it would make it more difficult for non-executive members of the board -- usually business people appointed by the Treasurer -- to make decisions in the national interest.

These arguments are a tacit admission that the RBA's part-time amateur policy board is incompatible with a more transparent framework for monetary policy governance in Australia. The RBA has effectively conceded the point that current Board members are subject to serious conflicts of interest. Macfarlane is unintentionally making a very good argument for the wholesale reform of these governance arrangements. Unfortunately, the RBA remains determined to hide behind these antiquated arrangements to avoid the increased scrutiny and public accountability which has become standard in other countries and is essential to the effectiveness of an inflation targeting regime.

posted on 27/11/2004

USD Down, Stupid Commentary Up. As the USD declines, the analysis of the currency realignment now under way gets increasingly unhinged. Here is *The Economist's* Buttonwood, arguing that the USD is about to lose its status as a reserve currency:

America has abused the dollar's reserve-currency role so egregiously that its finances now look more like those of a banana republic than an economic superpower.

This is just too rich for words. In the post-Bretton Woods era, whatever status the USD might have retained as a reserve currency has been due to the economic performance of the US. The enormous USD reserves and USD-denominated asset holdings of East Asia are in large part a function of managed exchange rate regimes run for mercantilist purposes. It is these managed exchange rate regimes that have brought about the global macroeconomic imbalances that the current market-led decline in the USD is now trying to correct. The problem is not the US current account deficit, but the recycling of excessive East Asian current account surpluses through USD asset markets, the only markets in the world deep and liquid enough to accommodate the massive scale of these mercantilist depredations.

At the end of the day, economic performance has nothing to do with whether your currency or assets are held by foreign central banks. The massive foreign exchange reserves of East Asia are a sign of economic weakness, not strength. The mercantilist mindset that thinks it can buy its way into world markets through manipulating exchange rates is about to face a massive reality check care of flexible exchange rates.

Far from facing a USD crisis, we are about to see a reverse Asian crisis, with unsustainable managed exchange rate regimes once again the main culprit.

posted on 25/11/2004

Asian Central Banks Face Reality. Stephen Ceccehtti highlights the realities facing Asian central banks:

We can start to see why governments with large dollar reserves would be concerned about both keeping the dollar from depreciating and ensuring that US treasury bond interest rates do not go up. Both of these would result in capital losses for the entities holding the foreign exchange reserves. Given that these reserves are huge - more than $800bn in Japan and more than $500bn in China - the potential losses are big, as is the potential embarrassment. A 10 per cent appreciation of the renminbi means a capital loss of $50bn for Chinese authorities. Assuming the duration of their bond portfolio is three to five years, a 2 percentage point increase in US interest rates means another loss of $30bn-$50bn.

It is hard to see a way for the Asians to get out of this bind without American help. Statements by the treasury secretary will not do the trick. Foreign *exchange intervention will be equally ineffective unless it signals that something fundamental has changed.*

It is not the US that depends on Asian central banks, but Asian economies that have made themselves dependent on managed exchange rate regimes. The growing calls for a 'managed' depreciation of the USD have more to do with protecting Asian central banks and economies than US capital markets. Only the East Asian economies lack the flexibility to deal with a sharp depreciation of the USD. The increasingly bizarre Andy Xie wants Asian central banks to become suicide bombers, realising their holdings of USD assets, presumably socialising their capital losses. Yet it should be clear by now that it is East Asia that will suffer the more serious macroeconomic adjustment in this scenario, as the East Asian economies have allowed official sector prejudices to override market imperatives for so long.

Stephen Ceccehtti argues for a US tax increase to narrow the budget and current account deficits. A less self-defeating approach would be for the US to cut government spending and make its recent tax cuts permanent. This would reduce the public sector's contribution to the current account deficit, although could actually widen the US current account deficit overall, due to the positive wealth effect this would have on the wider economy.

Intrade puts the chances of RMB revaluation at 67% by June 2005 and 82% by December 2005.

posted on 24/11/2004

Economic Freedom and Presidential Voting. Michael Crane's Political Junkie Handbook has added the following decomposition of Presidential voting by states' economic freedom score, as complied by the PRI:

Top 10

1) Kansas (Bush)
2) Colorado (Bush
3) Virginia (Bush)
4) Idaho (Bush)
5) Utah (Bush)
6) Oklahoma (Bush)
7) New Hampshire (Kerry)
8) Delaware (Kerry)
9) Wyoming (Bush)
10) Missouri (Bush)

Bottom 10

50) New York (Kerry)
49) California (Kerry)
48) Connecticut (Kerry)
47) Rhode Island (Kerry)
46) Illinois (Kerry)
45) Pennsylvania (Kerry)
44) Minnesota (Kerry)
43) Ohio (Bush)

42) New Jersey (Kerry)
41) Massachusetts (Kerry)
40) Louisiana (Bush)

At the same time, *Reason's* Nick Gillespie argues that sometimes 'economic freedom's just another word for nothing else to do.' Having lived in Singapore, which is top of the pops on international economic freedom rankings, I know what he means.

One upside to the US election outcome is that some people are turning to rational choice theory to, well, rationalise defeat:

In 2004, Fair's regression model (and several others) predicted that the election wouldn't even be close, that the incumbent Bush would win somewhere around 58 per cent of the vote.

If we give more credence to Fair's model than it perhaps deserves, the fact that Bush won only 51% of the vote can be interpreted optimistically, at least by Kerry supporters.

Fully 7% of the electorate - 8 million voters - resisted the compulsions of incumbency and the economy to vote for Kerry. Moderately impressive, if true.

In any case, my meta-conclusion is that there are no very compelling conclusions to be drawn about the electorate. Bush received more votes than Kerry. Period. I don't think this simple fact means the country supports the Bush agenda.

As we have suggested before, election commentary is alot like market commentary. The confident ex post analyses and explanations of election outcomes are conspicuous by their absence before the election itself.

posted on 23/11/2004

Ross Gittins: Cultural Protectionist. Ross Gittins supports cultural protectionism in the course of yet another spray at the Australia-US Free Trade Agreement:

The Government defended the here and now but sold our future to the Yanks. Consider, as just one example, our local-content rules for TV. We're allowed to keep the rules we've got but, should we ever decide to reduce the local-content proportion, we'll never be allowed to raise it again. And we've agreed not to impose local-content requirements on any new media that emerge in the future. The further we get into the future - on local content and many other things - the more we'll realise how much of our sovereignty we've given up and how much we're being pushed around by greedy US corporations.

Ross wants us to give up our consumer sovereignty to greedy local artists, writers and actors instead.

posted on 22/11/2004

More Moralising on the Current Account. *The Economist* continues the moralising on the US current account deficit:

If the dollar keeps falling, Europeans may feel that it is unfair that Europe should now suffer after years of profligacy by America's consumers and government. America is seen as a prodigal son who has squandered his wealth through wild living. His European brother, who has lived prudently, has no desire to bail him out now that his luck is running low.

The issue is not that Europeans live prudently, it is that they live lazily and inefficiently, which is why their potential growth rate is much lower than the US. The US can afford higher consumption, because it has better prospects for rising future income. Higher consumption and current account deficits reflect strong growth prospects. The US current account deficit is in fact symptomatic of the hard work and efficiency Europeans have failed to produce for themselves.

posted on 19/11/2004

Moral Panic Gives Way to Dollar Angst. The moral panic over the US current account deficit is now switching to angst about the US dollar's decline, yet it makes no sense to be worried about both. Those who view the current account deficit as a major problem should welcome the currency realignment that will narrow the deficit. It is not obvious why the US should be worried about a sharp decline in the value of its currency.

The contrary argument is that this depreciation will reduce the attractiveness of US assets, leading to a decline in the financing of the US current account and higher US interest rates. But the US current account must be financed, by definition. If capital inflows decline, it is because of a change in saving-investment balances, even if only on the part of foreign central banks. It is saving-investment behaviour that jointly determines current account balances, interest and exchange rates. Exchange rates adjust to realise the desired current account balance implied by these saving-investment preferences. Exchange rates do not cause current account balances, they reflect them, although they are obviously important in the process of adjustment.

The economies of East Asia face the much bigger problem. Either they continue their forced saving via managed exchange rate regimes, or they let their currencies go, facing a loss of competitiveness and capital losses on their foreign exchange reserves as official sector preferences give way to broader market-determined preferences over saving and investment. Realising their holdings of USD assets would only accelerate this process. The problem is not the appreciation of their currencies per se, but the fact that they have resisted market-led adjustment in their external accounts for so long, a sort of reverse Asian crisis. The East Asian economies face a much larger and more painful adjustment than the US, which can only benefit from this process.

posted on 19/11/2004

RBA Governor Macfarlane argues for the inappropriateness of targeting capitalist acts between consenting adults:

What would have happened if, instead, we had aimed our monetary policy at one of the other objectives put forward, say a substantially lower growth of credit. I am not sure whether we would have been able to achieve this, but I do know that the attempt to do so would have required setting a path of interest rates which was significantly higher than the one we did. This, in turn, would have meant that the outcomes for inflation and economic growth would have been lower than we actually achieved. I do not think this would have been a good economic result, and it certainly would have violated the letter and the spirit of our agreement on accountability. As I said earlier, a central bank cannot be accountable for everything, and our monetary regime recognises this, while at the same time choosing the right objective to be accountable for.

This, of course, does not mean that we ignore credit and asset prices. Movements in these variables can affect the future path of the economy and the evolution of inflation. So we need to study them closely, understand the forces driving their movements, and the risks that they pose. But they are not appropriate targets for monetary policy.

Unfortunately, the RBA's all care-no responsibility rhetoric on this and the related issue of house prices has managed to create the opposite impression. As Macfarlane's speech suggests, the RBA has still not quite adapted to the post-Wallis environment, in which it no longer has primary responsibility for regulating the financial system.

Last week, former PM Paul Keating criticised the RBA for targeting asset prices. Yet Keating as Treasurer, in conjunction with then RBA Governor Fraser, presided over a monetary policy that targeted the current account deficit, with disastrous consequences. Targeting the current account is just an indirect way of targeting capitalist acts between consenting adults, since current account balances are ultimately driven by household preferences over saving and investment.

posted on 17/11/2004

Post-Election Analysis of Prediction Markets. A student paper analysing the performance of Intrade's US Presidential election market (see under Exchange News):

Throughout the entire history of the market, with the small exception of a day or two after the Democratic National Convention, George Bush was favored to win the election…Amazingly, at 7:17 AM on election day, Intrade had all 51 states (DC included) correct. While exit polls throughout the day tainted the results, overall it appeared that Intrade predicted the Electoral College results perfectly the day before the election.

Of course, that was before the wild gyrations caused by early reporting of erroneous exit polls. The authors consider the implications of these gyrations for the efficiency of this market:

Although the markets wildly overreacted to exit polls, historically, exit polls have been a fairly reliable predictor of final results. With almost every early exit poll predicting a Kerry win, and with only the exit poll results being made available *(and not the methodology behind them), traders took into account all relevant information and acted instantly upon it. While the exit poll information ultimately was revealed to be inaccurate, traders did not have access to this private information, a fact supporting semi-strong efficiency.*

The authors also emphasise that prediction markets have a long and impressive history in relation to Presidential elections:

Futures markets for political events have existed in the United States for as long as there have been elections. These markets have been illegal during significant periods of US history due to gambling laws. Nonetheless, the activity has persisted. In the paper Historical Presidential Betting Markets, Rhode and Stumpf analyze betting markets for the period of 1868-1940 and find that the markets predicted the winner a month in advance in every case except for one. Furthermore, the markets offered more accurate predictions than other methods such as polls.

UPDATE: Pat Lynch argues that 'It's the economy stupid' was as important in 2004 as in 1872:

Bush won an election he SHOULD HAVE WON by a slightly lower margin than history would suggest. The economy mattered, just like it has for 132 years, in presidential elections. Don't kid yourself and buy into this "the economy is awful," crap. Unemployment is at historical lows, inflation is on life support, GNP growth has been great. By any measure, we're in great shape compared to the economies our fathers, mothers, grandfathers, and grandmothers faced. In virtually every election since the end of the Civil War incumbent presidents in comparable situations have won re-election.

As a background for this check out this article I did 5 years ago on the impact of the economy on U.S. presidential elections since 1872 for Political Research Quarterly. For those of you with lives who choose not to read it, the basic gist is easy - the economy has mattered since 1872 because politicians have campaigned on the economy and voters have linked economic performance to political.

posted on 14/11/2004

Smart People Believing Dumb Things. Do you work in a service industry? Did you know that you don't produce any wealth? That's according to Peter Schiff of Euro Pacific Capital, who had this to say on Friday's non-farm payrolls report:

The over-bloated service sector added another 272,000 jobs, while the beleaguered manufacturing sector lost an additional 5,000. In other words, the wealth producing sector of the economy lost jobs while the wealth consuming sector gained. The last thing the U.S. economy needs is more non-productive service sector jobs, which will only lead to higher trade deficits, as Americans imports more goods that service sector workers do not produce, and larger current account deficits, as greater interest payments become necessary to service growing external debts.

This common prejudice against service industries originates in the inability of many people to see value in non-physical output. It also explains much of the prejudice against housing as a supposedly 'non-productive asset.' It is not hard to see why people with this mentality would get so worked up about trade imbalances, because they cannot get their head around the idea that capital (and, yes, even services!) can be traded in the same way as physical goods and that there is no need for domestic consumption to be constrained by domestic production.

(via Capital Spectator)

posted on 9/11/2004

News Ltd vs the Reserve Bank. In recent years, News Ltd has targeted the RBA with numerous Freedom of Information requests, most of which have been designed to elicit embarrassing revelations about the perks available to RBA officers, the impressive wine cellar at Martin Place, etc. This game of trivial pursuit by News Ltd at the expense of the RBA has mostly been pointless and unfair, but I do support its current effort to get the RBA to release the minutes and voting records from previous Board meetings.

The RBA's senior officers and Board members have lodged affidavits with the Administrative Appeals Tribunal setting out their objections to the release of this information. The main thrust of their argument is that the release of this information will see Board members come under pressure from sectional interests. This is a self-defeating argument, since the whole point of having a part-time amateur policy board is that board members notionally represent their respective sectional or community interests. The affidavits effectively make a very good case for reform of the RBA Board, by showing that Board members are subject to conflicts of interest which are incompatible with running a transparent monetary policy regime.

In another submission, one of the Assistant Governors argues that release of this information would lead to 'costly speculation and volatility.' In my experience of financial markets, the RBA's lack of transparency and inability to communicate clearly has been one of the single greatest sources of speculative volatility, which imposes otherwise avoidable costs on the rest of the community.

As I have argued previously, there is a strong case for wholesale reform of the governance arrangements for Australian monetary policy to bring them into line with world's best practice. The Bank of England, the Fed and the Bank of Japan all release detailed minutes and voting records. If revelation of this information makes life difficult for current members of the RBA Board, they arguably should never have been there in the first place.

posted on 6/11/2004

Technical Analysis, Behavioural Finance and the EMH. A number of readers have questioned why a proponent of the efficient markets hypothesis would carry advertising for a number of technical analysis services. As it happens, I have a lot of time for technical analysis. The EMH and technical analysis actually make the same key assumption (price discounts everything), although they come to rather different conclusions about the implications of this assumption.

It has been shown in a number of studies that simple technical trading rules can yield excess returns over a buy and hold strategy. Momentum models, which are often no more than glorified technical trading rules, are widely used in the hedge fund industry. Such excess returns are often taken as evidence of some sort of market inefficiency. Yet the possibility of excess returns should come as no surprise from a market process perspective. The process of adjustment to new information is unlikely to be smooth and uniform due to a wide range of transaction, portfolio adjustment and information costs, as well as the cognitive biases highlighted by the behavioural finance literature. Free markets are important precisely because they are the best solution to coordination problems in a world of bounded rationality. The behavioural finance literature actually strengthens rather than weakens the case for free markets. Like the notion of the perfectly competitive market, the EMH is only an approximation of how markets work, but it is still the best approximation we have.

Bob Prechter's Elliott Wave International is the best known and perhaps most authentic exponent of a mode of technical analysis that has much in common with Mandelbrot's fractal geometry and demonstration of historical dependencies in financial market prices. They are offering some of their services free of charge for the next week. Click here to sign-up.

posted on 5/11/2004

Four More Years II. An important implication of Bush's re-election is that the Democrats will not get to choose a replacement for Alan Greenspan. Robert Rubin and Larry Summers are now out of contention. As Treasury Secretary, Robert Rubin presided over massive regulatory capture by Wall Street of international financial policy, conducted a highly interventionist approach to macro policy coordination and foreign exchange market intervention, as well as calling on Japan to adopt irresponsible macroeconomic policies. A similarly activist approach on the part of a Rubin Fed could have been disastrous.

Martin Feldstein is the most favoured of the Republican candidates, followed by Glenn Hubbard. John Taylor would be my preferred choice, assuming he actually wants the job. It would certainly give added empirical support for the existence of a 'Taylor rule' approach to monetary policy!

posted on 4/11/2004

Four More Years. The prediction markets had another good election, having consistently called it for Bush, although with some last minute gyrations as exit polls erroneously pointed to a Kerry win. Bloggers are being blamed for reporting on the exit polls and even for tanking the Dow. The bloggers' motto 'we report, *you* decide' was never more relevant. Numerous server outages on election night suggest that many people were turning to blogs for coverage, a welcome development.

The poor performance of the exit polls highlights many of the problems with opinion polling more generally. Asking someone how they voted is not the same as asking someone who they think will win. Many respondents may well support a particular party and yet have an entirely different view about who will win. Opinion polls effectively invite people to give a biased response, relying entirely on sample size to infer a result. Prediction markets perform better because participants are calling on a much larger information set and can take a probabilistic view of the outcome.

Malcolm Mackerras had a shocker applying his electoral pendulum methodology to the US. I have always thought his pendulum largely useless in the Australian context, because two-party preferred swings are not uniform and so a poor guide to the number of seats changing hands.

Ray Fair's econometric model got the direction right, although overstated Bush's margin. Fair updated his model with the NIPA data released on 29 October, yielding a prediction of 57.70 percent of the two-party vote for President Bush.

Tom Wolfe noted that the best argument for voting Republican was the opportunity to wave-off those people who had threatened to leave the country in the event Bush was re-elected. To this end, Harper's has produced a useful guide to expatriating yourself from the US. Just stay away from Australia. We already have enough people with no sense of political perspective.

Intrade is already offering contracts on the 2008 Presidential election:

posted on 4/11/2004

The US Current Account Deficit Again. The *FT* runs two views on the current account deficit by Richard Cooper and Obstfeld and Rogoff. Needless to say, Richard Cooper has the better of the argument:

The US economy accounts for well over one-quarter of the world economy and about half its marketable financial assets. Furthermore, it provides higher returns on real investment than do Europe or Japan, and offers more reliability and security on these returns than do emerging markets. Is it inconceivable, in today's increasingly globalised world, that savers will want to put 10-15 per cent of their savings into the US economy, a share that decreases over time? The large and rapidly growing pool of savings in China and India have hardly been tapped, bottled up by exchange controls. Investment opportunities in the US economy would be highly attractive to many newly wealthy Chinese and Indians; $500bn a year in net private foreign investment may actually be on the low side...

As commentators frequently note, the continuing current account deficit reflects a deficiency of savings in the US relative to investment there. However, it also reflects an excess of savings in the rest of the world relative to investment in the rest of the world. Any attempt to reduce the US deficit abruptly, other than through a spontaneous but unlikely surge in domestic investment in many other countries, would undoubtedly produce a world recession.

By contrast, Obstfeld and Rogoff present the usual tired and discredited IMF orthodoxy:

But what to do? Given that the federal government's own impecuniousness is a big part of the problem, raising taxes would seem like a good place to start.

Ah, yes, raising taxes; that'll fix everything!

posted on 1/11/2004

***The Economist* endorses John Kerry,** but succeeds only in damning him with faint praise. The magazine's case against Bush is not convincing in the least (as a Bush supporter, I could make a more compelling argument against his re-election myself). It is almost as if *The Economist* is attempting to make an ironic case for Kerry (like the argument which says Kerry should be made to face his worst nightmare and actually have to 'report for duty'), but that would be giving them too much credit. *The Economist* is just grandstanding to sell copy. The weakness of their argument gives the game away.

posted on 29/10/2004

Libertarians for Bush. Tom Palmer reproduces an open letter from former Libertarian Presidential candidate John Hospers, advocating a vote for George Bush. While Hospers overstates his case and uses some seriously overblown rhetoric, I would agree with his bottom-line statement of political strategy:

If the election is as close as it was in 2000, libertarian voters may make the difference as to who wins in various critical “Battle Ground” states and therefore the presidency itself. That is the situation in which we find ourselves in 2004. And that is why I believe voting for George W. Bush is the most libertarian thing we can do.

We stand today at an important electoral crossroads for the future of liberty, and as libertarians our first priority is to promote liberty and free markets, which is not necessarily the same as to promote the Libertarian Party. This time, if we vote Libertarian, we may win a tiny rhetorical battle, but lose the larger war.

posted on 28/10/2004

The AEI-Brookings Joint Centre report on the results from some of their experimental political betting markets, concluding:

market participants strongly believe that Osama bin Laden’s capture would have a substantial effect on President Bush’s electoral fortunes, and interestingly that the chance of his capture peaks just before the election. More generally, these markets suggest that issues outside the campaign – like the state of the economy, and progress on the war on terror – are the key factors in the forthcoming election.

The fact that performance in the Presidential debates and the convention speeches had little impact on market prices is an interesting result. The professional commentariat generally over-interpret and place far too much weight on internal campaign dynamics at the expense of larger issues. This was also apparent in Australia’s recent federal election campaign, which still has some pundits arguing that the ALP ran a ‘good campaign’ and attributing the ALP’s massive defeat to trivia such as the timing of policy announcements. The results from political betting markets suggest that campaign dynamics are not that important and that the smart money looks through these dynamics to the larger issues.

These markets still favour Bush. I am much less confident than the market on this score. It remains to be seen whether the betting markets call the US Presidential election as well as they did the Australian federal election.

You can place your own bets via the following link, which shows live prices:

posted on 27/10/2004

Kerry and the Markets. Stephen Roach opines:

For what it's worth, I suspect that the dollar's slide will accelerate sharply in the aftermath of the US presidential election — probably more so in the event of a Kerry victory than would be the case in a Bush win. Senator Kerry's focus on trade and jobs puts him more in the camp of embracing market-based resolutions to global imbalances.

I don't see much evidence of Kerry embracing market-based anything, even relative to his conservative opponent. Kerry's statements on outsourcing and other issues suggest he has a decided preference for protectionist and interventionist responses to 'global imbalances.' The last Democratic Administration also had a sorry record of supporting official intervention in foreign exchange markets, in sharp contrast to the current Administration's more laissez-faire approach to exchange rate management. Roach argues:

In either case, however, the dollar's coming depreciation will pose a great challenge for an unbalanced global economy.

If anything, the US dollar's prospective depreciation will bring about the very 're-balancing' Roach argues is necessary. Market-determined multilateral real exchange rate developments help ensure that current account balances reflect underlying national preferences for saving and investment. It is these preferences that ultimately determine current account positions and the exchange rates required to support those positions.

posted on 26/10/2004

The AEI as Monetary Policy Doves. The AEI has taken a decidedly dovish turn in its analysis of monetary policy in recent years. John Makin calls for a break on further rate rises from the Fed. Part of Makin's argument is that the US economy remains sluggish despite considerable monetary and fiscal stimulus. This suggests that monetary policy in the US is perhaps not as potent as it is sometimes given credit for. To that extent, further rate rises are the least of the forward-looking risks to the US economy. To the extent that some of these potential downside risks are realised, monetary policy is already accommodative and can be made more so.

Makin suggests a number of fiscal policy measures that strike me as potentially more potent, in particular, generating additional wealth effects from existing tax cuts:

Although the leeway for further tax cuts is limited, current tax cuts should be made permanent in order to give households and firms greater confidence about the future tax environment while avoiding additional tax burdens to the substantial drags already hitting the economy from higher energy prices. Beyond that, marginal tax rates should be further reduced with revenue losses recouped by eliminating tax preferences.

Permanent expenditure cuts would also be needed to support any positive wealth effects from permanent tax cuts. There is a tendency to overstate the importance of monetary policy, while ignoring the potential for inducing behavioural responses from fiscal policy measures that extend well beyond the direct contribution of fiscal policy to aggregate expenditure.

posted on 20/10/2004

Manipulation of Prediction Markets. Don Luskin argues that the Tradesports Bush re-election contract has been the subject of attempted market manipulation via massive sell-orders. Barry Ritholtz has sent me a press release from Intrade on the subject (the press release has not yet appeared on the Intrade web site):

A wave of heavy selling hit the George Bush re-election contract on Intrade Friday driving the market down to all time lows before recovering.

"Our exchange operations staff continuously monitors our markets and reported that a very large sell order hit the Bush Presidential contract at approximately 1:30 pm EST on Friday October 15th", said Chief Executive Officer John Delaney.

"The sell order caused the market to trade at new lows before recovering to earlier levels. The exchange has more than 40,000 members, after assessing there was no news to cause the decline, traders quickly started buying and within 3 minutes the market fully recovered to price levels seen prior to the sell order being executed" says Delaney.

Some question if the market can be manipulated with such heavy selling or buying.

"All emerging markets will experience volatility, we are gratified that the market recovered so quickly and without any intervention on our part. This demonstrates the market's resiliency, that the Intrade exchange is the destination for serious traders in political contracts and that the utility of the market as a price discovery mechanism is firmly intact" says Delaney.

The Intrade Bush contract has become the battle ground of wills between a cadre of large, well financed rogue traders seemingly bent on driving down the Bush re-election contract and a growing list of financial traders who think they can predict the outcome of this election.

Barry has questioned the depth, liquidity and information content of markets like the IEM in a number of posts on his blog. Notwithstanding the price volatility, these markets do appear to be quite resistant to sustained manipulation. Whoever is responsible (Luskin and Delaney both mention Soros), they do not appear to be getting much of a sustained bang for their buck.

Intrade also offer a guide to whether we will see a repeat of the 2000 election outcome:

The Bush popular vote contract (right) currently trades at a discount to the electoral vote contract. If you subtract the price of the Bush popular vote contract, currently trading at 52, from the Bush electoral vote contract, currently trading at 55, that gives a 3% probability of Bush winning the electoral vote but not the popular vote as he did in 2000. Traders are taking this trade as cheap insurance against a replay of the last presidential election.

posted on 19/10/2004

Eurostat Eurotrash. On previous occasions, we have pointed out that the fiscal underpinnings of monetary stability in Europe have been steadily eroded because of the way in which the Growth & Stability Pact has been progressively undermined to the point of becoming a dead letter. Wolfgang Munchau highlights the extent to which national accounting in the eurozone has become a sham under Eurostat:

National accounts should provide a true and fair statement of a country's financial position. This is not the case in the eurozone. The officially recorded deficits are those that governments have failed to hide from public view. As an economic statistic, they are close to meaningless. Yet the stability pact, the main instrument of policy co-ordination in the eurozone, relies almost exclusively on that statistic to enforce the rule that reported deficits must not exceed 3 per cent of gross domestic product. As long as the quality of national accounts remains in doubt, it would make a lot more sense to focus on a country's level of outstanding debt and future public-sector obligations, especially pension liabilities. By that measure, of course, several countries of the eurozone would be technically bankrupt and no government is likely to admit that.

Munchau calls for the creation of a European equivalent of the US Congressional Budget Office. Yet it should be clear by now that these problems are inherent in the euro project itself.

posted on 18/10/2004

Oil and Incumbency. Previously, we noted the negative correlation between the implied probability of a Kerry win on the IEM and the S&P500. My own view is that causality probably runs from the negatives impacting the S&P to greater confidence in a Kerry win, rather than the other way around. Barry Ritholtz also points to the negative relationship between oil prices and support for the incumbent, George Bush. This is one of several reasons why I am pessimistic about the prospects for his re-election in November.

posted on 16/10/2004

The Centre for Independent Studies is seeking applications for its 2005 Liberty & Society program and Ross Parish Essay Prize:

Liberty and Society, a unique programme for young people living in Australia, New Zealand and other surrounding countries. The goal of Liberty and Society is to create an intellectual environment where ideas and opinions about what makes a free society can be discussed, argued and learnt. 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.

Having attended three Liberty & Society seminars in both the US and Australia, I can highly recommend the experience to prospective applicants.

posted on 15/10/2004

The World Economic Forum's Global Competitiveness Report rankings for 2004-05 have seen Australia slip from 10th to 14th. Australia tends to bounce around in rankings of this type, with the change from year to year probably saying more about what is happening in other countries than in Australia. Moreover, you have to question a methodology that ranks Australia behind Germany and Japan: that sort of 'competitiveness' we can do without!

Leaving aside questions of methodology, the issue of competitiveness does point to the importance of the re-elected federal government's fourth term agenda, or lack thereof. Apart from the ad hoc spending commitments made in the run-up to the election and a pile of blocked legislation from its previous term, the government has no real fourth term agenda. Despite receiving one of the strongest electoral endorsements in the post-war period, the Coalition is woefully under-prepared for government. No doubt many will argue that the Coalition's success was predicated precisely on its failure to articulate a fourth term reform agenda. In other words, the government has no mandate for radical reform. However, with a prospective majority in the Senate, it does have an unprecedented mandate to govern. The government needs to capitalise on this opportunity by formulating and implementing a fourth term agenda worthy of its mandate.

posted on 14/10/2004

Family First. Those worried about the prospective role of Family First on the Senate cross-benches might consider how far we have already travelled down this road. Tim Blair posts the following:

A friend at Brisbane Airport just tried to access comments at this post using an on-site computer, and got the following message: "Access denied by CyberPatrol. This website's content is inappropriate. Category: drugs, alcohol, and tobacco."

posted on 13/10/2004

Post-Election Spin Control. There is much debate in the blogosphere about the role of Iraq in Australia's election outcome. Pundits will always interpret election outcomes in a manner favourable to their own cause. I have no trouble with the view that the economy was the decisive factor in explaining the result. Indeed, I suggested at the outset that Labor was probably buried even before the campaign began because of the economy's unprecedented strength. The idea that the result is attributable to such trivia as the timing of the release of policies simply beggars belief.

However, just because an issue may not have been decisive in the final result does not mean that it was not an issue in the campaign. A large number of very prominent Australians put an enormous effort into trying to turn the election into a referendum on Iraq and related issues and the ALP were fellow travelers in this effort. Having not got the result they wanted, it is a little too convenient to suddenly dismiss Iraq as irrelevant to the outcome, since they were the only ones arguing that the result should in fact be decided almost exclusively on the basis of this issue. If the electorate prioritised the economy in finally casting their vote, it can only be because the anti-government posturing over Iraq had no credibility or resonance. Similarly, it would have been reasonable to attribute a hypothetical Coalition defeat at least in part to Iraq, because it would have raised the obvious question as to why the government had not be returned, despite a very strong economy.

As I have suggested previously, the election was less of a referendum on Iraq than on the relevance of the people who said it should be. As far as the actual election result is concerned, the left became the authors of their own nightmare.

posted on 13/10/2004

And the winner is… Kydland and Prescott win the 2004 Nobel in Economic Science for their contributions in relation to dynamic inconsistency and real business cycles. Of all the names in contention, these two were certainly the most deserving. It is good the committee recognised Kydland as well as Prescott, even though Prescott was considered the leading contender. As those familiar with the literature will appreciate, they have been co-authors on so many papers, the two are almost synonymous. On previous occasions, the committee has arguably overlooked equally important contributions from others in the same field, awarding the prize to Solow and not Swan, Buchanan and not Tullock. It is pleasing to see that Tullock was still in the running in this year's betting market. Needless to say, the market got the result right!

posted on 12/10/2004

Post-Election Spin Control. In the wash-up from the election, only a handful of commentators have recognised the role of pervasive intellectual failure in the ALP's crushing defeat. As Paul Kelly notes:

The voters don't love Howard. But he has a link to the Australian people through his performance, strength and character that his critics deny, misjudge and misinterpret. This repeated intellectual failure has cost Labor severely.

Similarly, Greg Melleuish observes:

If we are to believe the stream of books and articles turned out by the academic and media elites over the past few years, Howard and his Government are about the worst thing that has ever happened to Australia…The problem is that they hate Howard so much that they can only see him as a caricature. They see him as an unchanging, almost demonic, figure whose greatest sin is not to take notice when they scold him. The result is that they have never been able to understand and appreciate his strengths, preferring to dwell on his weaknesses. Blinded by their dislike they have consistently underestimated him.

Alan Ramsey is perhaps the best example of this kind of pervasive intellectual failure. Ramsey is now suffering the anti-democratic meltdown characteristic of late-stage Howard Derangement Syndrome, blaming the ALP's defeat on:

voters' gullibility, their ignorance, their taxes and, in the end, their greedy self-interest.. This time the people's will has got it dreadfully wrong.

posted on 11/10/2004

Federal Election Result. My random walk forecast of no net change in the 83 seats notionally held by the Coalition proved reasonably accurate, with the Coalition currently looking at 86 seats. I also suggested that to the extent there is a deterministic component to the two-party preferred vote linked to the economy, a Coalition majority in the Senate was plausible. While the Coalition will perhaps fall short of an absolute majority, a functional majority in the Senate looks likely.

Rational choice theorists are not permitted to read too much into election outcomes, but for the left who sought to make Iraq and related issues central to the campaign, the election is a stunning repudiation on their own terms. Anti-Howard campaigner John Valder was on Insiders this morning, sounding about as rational as Pauline Hanson on a bad day. These people are as embarrassing to themselves as they are irrelevant.

I do not see this result necessarily translating to the US in November, as the conservative press in the US will undoubtedly try to argue. The key difference is that Howard has had the benefit of a very strong domestic economy, whereas Bush has been unfortunate enough to be stuck with a weak one. Had Howard seen a recession during his most recent term, the result might well have been different.

This will be the first time in nearly a quarter of a century that an Australian federal government has had a functional majority in the Senate. The re-elected government has an unprecedented opportunity to institute reform free of partisan obstructionism. For those of us who supported the government despite rather than because of its big spending conservatism, it will be more than usually important to keep the government on the straight and narrow and ensure that this opportunity is put to good use. It will also be important for classical liberals to resist any resurgence of moral authoritarianism arising from Family First's prospective new role on the cross benches in the Senate. Social conservatives are typically hostile to radical economic reform and so their more prominent role in Australian public life should be viewed cautiously. They have already ruled out supporting the privatisation of the rest of Telstra, for example.

No election post-mortem would be complete without some fun at the expense of *The Economist*, which had this to say last week:

The polls show a result too close to call. Considering the huge domestic unpopularity of the war in Iraq, in which Australia has been a valuable participant, that is no mean achievement for Mr Howard…Iraq convulsed Australia. A clear majority of its citizens believe the war to have been wrong.

The Economist thought Iraq so important, it claimed that 'the foreign minister is fighting for his political life' and that there was 'a good chance' he would lose his seat. For the record, the foreign minister was returned with 63% of the two-party preferred vote.

posted on 10/10/2004

Polling Day, Wentworth. One of the houses in the neighbourhood was vandalised overnight with ‘Throw Howard Overboard’ in three foot high orange spray paint. If the owners of the house weren’t planning on voting for Howard yesterday, I’m sure they are today. Much of the local anti-Howard graffiti seems to be by the same people responsible for some anti-Semitic graffiti as well. It is helpful to know a vote for Howard is a vote against petty vandalism and anti-Semitism.

The local booth had a single Peter King worker, a woman so old this election is likely to be her last. Peter King will have to rejuvenate his support base if he wants to contest future elections.

The local booth is an Anglican Church, which uses election day as an opportunity for fund-raising from the temporarily captive market created by compulsory voting. The local church is renowned for its political correctness, having given up on actual religion a long time ago, but I thought today’s sausage sizzle and cake stall ‘in aid of Darfur’ was a tad insensitive!

posted on 9/10/2004

The Left’s Cognitive Dissonance Trap. On election eve, I am sticking with my random walk forecast of no net change in the 83 seats notionally held by the Coalition. I have noticed the conservative press in the US arguing that the election is a referendum on Australia’s participation in the Iraq war. This overstates the extent to which Iraq has featured in the campaign, but there is at least one related sense in which this is true. In the lead-up to the election, an endless parade of worthies and luvvies have been signing-up to statements attacking the government on Iraq and related issues. Arguably, the worthies and luvvies have turned the election into a referendum on their own relevance, setting themselves a cognitive dissonance trap in the process. Much of this posturing has been couched in the language of democratic virtue, which can only make the prospect of repudiation by the electorate all the more difficult to rationalise, although no doubt we shall see some heroic attempts (Howard lied, stole the election, etc). The pathological dislike many express for the current government is way out of proportion to any substantive policy differences between the major parties on the issues they claim to care about. It shows a lack of common sense and judgment on the part of many prominent Australians.

posted on 8/10/2004

Debating the Size of Government. Stephen Cecchetti argues that the size of government should be central to economic policy debate:

If the US government had to adopt the generally accepted accounting practices required of corporations, we would realise that unfunded liabilities arising from future medical care and social security payments run to more than four times gross domestic product. We need an informed debate about what, as a society, we should do about the government's promises in this respect. Such a discussion might start with three key questions: First, how big should the government be? Second, what are the government's duties? And third, who is going to pay for it?

A welcome innovation in Australia's federal election campaign was Mark Latham's undertaking to actually reduce the Commonwealth revenue and outlays shares of GDP. Unfortunately, it is a promise that has little credibility when coupled with his open-ended commitments to Whitlamite spending programs in areas like health.

John Quiggin has been arguing that the federal election somehow marks a new triumph of social democracy over the 'economic rationalist' agenda of the 1980s and 1990s. But this agenda was in fact mostly a social democratic project, implemented by Labo(u)r governments in Australia and NZ to put the welfare state on a sounder economic and fiscal footing. The reforms of the 1980s and 1990s barely touched the core elements of democratic socialism, because that was never the intention. Every Australian government in the post-war period has presided over a secular expansion of the state at the expense of civil society and this government has been no exception.

posted on 7/10/2004

The US Current Account Deficit Again. David Frum has a nice piece on why Americans should not be worried about the current account:

The current (account) deficit is often presented as if it were some kind of moral indicator: The lower, the more virtuously frugal. But right now, the United States is spending a great deal overseas because the price of oil has risen high; foreigners are buying relatively little in the United States because the European and Japanese economies are so sluggish; and foreign investment is surging into the country for lack of better global alternatives.

The American current account deficit, in other words, is an indicator of the strength and vitality of the U.S. economy. The only thing scary about the statistic is what it reveals about the weakness and fragility of the other major world economies, especially those of Europe...

If you must worry, worry about the Japanese slowdown or European unemployment or the high price of oil. But for the U.S. current account deficit, probably the best advice to follow is that which my old boss Bob Bartley of the Wall Street Journal used to offer, before his untimely death: "Stop collecting that damn statistic."

I would disagree with the characterisation of the Japanese economy as sluggish in a cyclical sense (it is currently testing 'bubble' era peaks on some indicators), but there is a strong relationship between Japan's current account surplus and its low potential growth rate.

Frum needs to spend more time with his colleague Desmond Lachman, who invokes Niall Ferguson's greatly over-stretched historical analogies with Victorian England to argue:

It is never pleasant for presidential candidates to talk about the real sacrifices that might be needed to put the country's external finances on a sounder footing and to reduce dependence on foreign financing. However, on the basis of all too many precedents, one must fear that failure to begin the process of correcting the U.S. external deficit soon runs the very real risk of another dollar crisis with all its attendant disruptions to U.S. financial markets and the U.S. economy.

If only American's would accept a lower standard of living like Germany and Japan and those nasty external imbalances would go away! This is not to say that there are not problems with US fiscal policy or with China and Japan's managed exchange rate regimes, as Lachman suggests. Yet Lachman is one of those who simultaneously worry about the current account deficit and have an almost equal fear of its cure, exchange rate depreciation. The great thing about flexible exchange rates is that they can offset much of the damage policymakers might otherwise inflict on their own and other economies. The dollar 'crises' of 1985, 1987 and 1995 were actually far less of a problem than the international macroeconomic policy coordination and joint foreign exchange rate intervention episodes they inspired. It is only when policymakers stand in the way of market-led exchange rate developments that the problems start.

posted on 6/10/2004

The Bubble that Wasn't. Alan Kohler continues his refreshing house price 'bubble' scepticism:

the Australian property market has not crashed, despite all the warnings. If anything, it's bouncing. Buyers are back; lending data is strong; some suburbs are quite hot again. At worst, the overall market has plateaued after a correction of 5 to 10 per cent in the first half of this year.

One major bank told me yesterday that, according to loan applications coming through, values in many areas have returned to where they were before the correction began last November…

So, paradoxically, if interest rates rise once or twice more (and that's all) and more importantly are not cut, then the 5 or 10 per cent correction in property values we have seen so far this year might be the full extent of Australia's much-predicted property crash. That would be amazing.

Bubbles burst; so, if it doesn't burst, it wasn't a bubble.

That last statement highlights the bankruptcy of most 'bubble' talk. If a bubble can only be identified after the event, then it is little more than a convenient ex post rationalisation for asset price deflation. Similarly, Ross Gittins claims:

It's clear financial markets aren't always efficient, as any number of stockmarket crashes demonstrate.

Just because market expectations are sometimes invalidated ex post does not necessarily make them irrational ex ante or imply that markets are inefficient. Those who think that every asset price inflation and deflation they don't understand must be symptomatic of an irrational 'bubble' or evidence of market inefficiency show they do not understand the role of markets as discovery processes. If markets did nothing more than mirror known fundamentals or valuation metrics, they would be largely unnecessary.

posted on 5/10/2004

Advertising at Institutional Economics. Institutional Economics now carries Blogads (see sidebar on left). Institutional Economics reaches ~1700 unique visitors a week (average for last 12 months) in financial markets, media, government and academia, mostly from the US and Australia, but many other parts of the world as well. Rates are as low as USD 20 for one month.

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posted on 4/10/2004

The Battle for Wentworth. Centrebet has opened its book on key marginal seats for Australia's upcoming federal election. For Wentworth, Centrebet is offering $1.75 for the Liberal's Turnbull, $2.40 for the ALP's Patch and a very wide $5.00 for Peter King. Note that Patch has slightly narrower odds on winning Wentworth than the ALP has of winning nationally ($2.55). Punters seem to think Peter King's most likely contribution will be to help Labor over the line in Wentworth.

There is also a book on whether Pauline Hanson will get into the Senate. The $1.33 being offered on 'No' (implied probability of 70%) strikes me as good value!

It is notable that Centrebet's odds for the overall election result still strongly favour the Coalition, somewhat at odds with the media conventional wisdom. Marginal Revolution notes that the Tradesports Bush contract went up in price during the course of the Presidential debate, but promptly fell as the post-debate media spin took hold. Perhaps Australians are more spin resistant?

posted on 3/10/2004

***The Economist* 'Down Under' (Cringe!)** Have you noticed how The Economist is incapable of writing a story about Australia that doesn't include 'down under' or the 'lucky country' in the headline? The Economist's fondness for hackneyed phrases is actually quite handy, because you can easily configure a search engine to track its coverage of Australia.

This week, Buttonwood writes about the outperformance of the Australian stockmarket and concludes 'Australia's good fortune relies on China avoiding a stumble.' Like many others, The Economist misses the significance of China for the Australian economy. China accounts for 12% of Australia's merchandise exports. Yes, China is our fourth largest export destination, but this only serves to highlight the very low weight of any single destination for Australia's exports.

The real significance for the Australian economy lies in our merchandise trade *deficit* with China. Australia benefits as much from falling prices for Chinese exports to the rest of the world as from rising prices for our exports to China. Australia is experiencing double-digit annual growth in its terms of trade, with much of the improvement in recent years driven by falling import prices, in addition to rising export prices. This in turn is powering very strong growth in Australia's national income.

Were the Chinese economy to hit the wall, Australia would export the slack somewhere else (Australia's exports are highly fungible), while still benefiting from China's exports to the rest of the world.

Of course, not everyone is happy about this situation. The protectionist elements of Australian manufacturing are already showing signs of nervousness about an Australia-China FTA.

At least China gives the Economist an excuse to give house prices a rest as its mono-causal explanation for the Australian economy.

posted on 2/10/2004

Johan Norberg, author of *In Defence of Global Capitalism*, has a blog devoted to liberalism, capitalism and globalisation.

posted on 30/9/2004

Libertarian Independents for the Senate. As mentioned on a previous occasion, a couple of libertarian independents will be running for the Senate in NSW. This is the first time libertarians have run at a federal level since the (ironically named) Workers/Progress Party in the 1970s. To the best of my knowledge, it is also the first political campaign in Australia to be organised entirely within the blogosphere. Libertarianism is not a strong political tradition in Australia. In New Zealand, which has a more libertarian-friendly political culture, the Association of Consumers and Taxpayers (ACT) have had considerable political success in an electoral system that has some similarities with that for the Australian Senate. While these independents are a long way from being able to replicate the success of ACT, it is a worthy effort that deserves encouragement. They also have the most amusing slogan of the campaign, in line with their policy of abolishing compulsory voting: "Vote for us and you will never have to vote again!"

Before casting an above the line vote for the libertarians (group W on the NSW Senate ballot), you should check their preference allocation. You may want to allocate your preferences differently by casting a below the line vote.

posted on 29/9/2004

Peter King is too shallow and transparent, even for the Greens. King is now running the ridiculous and circular argument that the Prime Minister should intervene to support him directly, because his supporters' preferences will leak to the Labor Party candidate:

Nearly half of his supporters said in last week's poll they would give their second preference to Mr Patch, rather than Mr Turnbull.

Mr King has appealed the Prime Minister, John Howard, to publicly support him over Mr Turnbull as a way of defeating Labor in the seat.

In more bizarre election news, the Socialist Equality Party candidate for the NSW Senate, affiliated with the International Committee of the Fourth International (yes, it still exists) cites the International Monetary Fund as an authority on Australia's economy. I'm not sure if this says more about the opportunism of the left, or the quality of the IMF's analysis.

posted on 28/9/2004

Australia's Yield Curve Inversion & Fiscal Policy. The 90 day bill-10 year bond spread has been modestly negative for the past two weeks. An inverted yield curve is one of the best predicators we have of a recession. The last time the yield curve inverted (using monthly data) was between May 2000 and February 2001. It is not widely appreciated that Australia experienced a technical recession in domestic final demand at the end of 2000, with headline growth only being rescued by a positive contribution from net exports. The previous major sustained yield curve inversion began in June 1988, warning of the early 1990s recession, and did not end until April 1991. Not all historical yield curve inversions have been followed by recessions, as opposed to slow-downs, and the current modest inversion may not be sustained, but it is a signal that should be taken very seriously.

The prospect of recession highlights the dangers of the government's expansion of structural spending commitments in recent years and in the context of the current federal election campaign. It is unfortunate that it will probably take a recession to restore some semblance of fiscal discipline on the part of the next government of either party. This will be much harder to achieve given the expansion in entitlement programs that has characterised the current government's fiscal policies.

It should be said that there are almost no implications for interest rates in the bottom-line differences between the fiscal programs of the two major parties. Of all the factors influencing interest rates, the budget balance is probably the least significant, within very broad limits. Rather than chastising the government for putting pressure on interest rates, we should be lashing the government for robbing us of our economic freedom by further locking us into failed schemes for the public provision of private goods and services and an unrestrained redistributive state. The few basis points on the average mortgage that might be due to the budget balance is the least of the costs associated with unrestrained government spending.

UPDATE: Alan Wood has some advice on what to do with budget surpluses, from Alan Greenspan.

posted on 27/9/2004

Laissez Faire Books has a 15% off everything sale through to 15 October. LFB claim to be 30% cheaper on average than Amazon and offer to match Amazon prices on any item. It’s also a great way to support Institutional Economics.

posted on 24/9/2004

33rd Conference of Economists. I will be giving a paper at ACE2004 next week. The session details are as follows. I am currently scheduled first in my session, approximately 13:45 to 14:15.

Title: Monetary Policy in Japan's Great Recession: A Monetary Disequilibrium Approach
Session Name: Macroeconomic Policy Modeling
Date: Monday, 27 September, 2004
Time: 1345 to 1515
Seminar Room: 312
Your Presentation Time: 1345 to 1515
Question Time: 10 minutes
Chairperson: Don Harding

IE readers who will be at the conference are invited to drop in and say hi.

posted on 24/9/2004

Alan Reynolds takes on the platitude writers at *The Economist* on the subject of deficits and interest rates. Reynolds’ arguments are also relevant in the context of the current Australian federal election campaign, where the two major political parties have been trying to convince us that the negligible difference in the bottom-lines of their respective fiscal programs might have implications for interest rates.

The Economist (11 September) repeats the editors' habitual lecturing about a "reckless" U.S. budget deficit, which amounts to 3.6 percent of GDP. In a related essay, C. Fred Bergsten recycles his ill-fated "hard landing" scares of the 1980s, based on a metaphysical assertion that "larger budget deficits will produce larger American trade deficits. . ..[and] higher interest rates."

The statistical tables at the back of The Economist, by contrast, tell a different tale. Budget deficits in France and Germany are just as large as in the U.S., and the budget gap in Japan is twice as large. Yet all three countries have a current account surplus, not "twin deficits." And the interest rate on 10-year government bonds is only 1.6 percent in Japan.

Australia, by contrast, has maintained budget surpluses since 1998. Yet Australia's current account deficit is larger than that of the United States, as it was in all but one of the past six years. Australia's 10-year interest rate is 5.6 percent -- substantially higher than the U.S. rate of 4.2 percent. Canada, with a budget surplus since 1997, also has a higher interest rate than the U.S, 4.7 percent. These are regular patterns, not anomalies.

From 1994 through 2003, annual budget deficits averaged 5.8 percent of GDP in Japan, compared with 1.6 percent in the U.S. If budget deficits really increased interest rates and current account deficits, then Japan should be experiencing high interest rates and a large current account deficit by now. Countries with budget surpluses, like Australia, should be experiencing much lower interest rates and current account surpluses. The facts obviously don't fit the conventional theory...

What is done about budget deficits usually matters a great deal more than the deficits themselves. Alberto Alesina of Harvard University and three co-authors unveiled a major long-term study of fiscal policy changes in 18 economies for The American Economic Review, September 2002. What they found was that "fiscal stabilizations that have led to an increase in growth consist mainly of spending cuts, particularly in government wages and transfers, while those associated with a downturn in the economy are characterized by tax increases." Ireland prospered after cutting spending by an amount equal to 7 percent of GDP (equivalent to two U.S. defense departments), then slashing marginal tax rates on profits, capital gains and salaries.

While on the subject of *The Economist*, I almost died laughing when on a recent episode of *The Simpsons*, Homer gets upgraded to first-class, pulls out *The Economist* and promptly starts mouthing the platitudes contained within.

posted on 23/9/2004

I will be the first to admit that rational choice theory cannot explain this:

In 2003, generous and civic minded citizens sent the US Treasury 1,277,423.40 USD in gifts to help reduce the public debt. The voluntary program is run by the Bureau of the Public Debt. The Bureau can accept cash, government securities or personal property on the condition that the property can be sold and the proceeds used to reduce debt held by the public.

This program actually sounds like a rather cynical exploitation of the ‘civic minded’ to me. All those Crooked Timber readers wanting to further demonstrate the invalidity of RCT are invited to reduce my private debts via the Paypal button.

posted on 22/9/2004

An open letter by a group of Australian economists draws attention to the lack of serious economic policy debate in the context of the current federal election:

We need to focus on building the next economic miracle, not spending the proceeds of the most recent one.

While I disagree with many of their policy prescriptions, the authors are correct in arguing that prosperity has bred complacency on the part of policymakers. The two major parties have engaged in bidding wars on health and education spending which fail to address underlying structural issues. The government has taken largely cyclical budget surpluses and converted them into structural spending programs. The ALP has at least attempted to fully fund its spending commitments. Unfortunately, many of these funding measures are in some ways even worse than running down the surplus or going into deficit: reducing the rate of tariff reduction and increasing other regressive taxes.

It is difficult to take seriously the claims of either of the major parties to be addressing future unfunded contingent liabilities via an inter-generational fund, when at the same time they are continually entering into new structural spending commitments. The focus should instead be on dismantling failed public spending programs in relation to what are essentially private goods and services, lowering taxes and restoring consumer sovereignty. You won't hear that from anyone in this election; not even from Australia's economists.

posted on 22/9/2004

Amartya Sen pays tribute to Hayek on the 60th anniversary of *Serfdom*:

As someone whose economics (as well as politics) is very different from Hayek's, I would like to use the 60th anniversary of The Road to Serfdom to say how greatly indebted we are to his writings in general and to this book in particular. Dialectics is critically important for the pursuit of understanding, and Hayek made outstanding contributions to the dialectics of contemporary economics.

posted on 21/9/2004

Voting in an Illiberal Electoral System. Australia is one of the few countries in the world in which voting is compulsory, with penalties applying for both non-voters and those who fail to register to vote. The usual rational choice theory calculus, which demonstrates that the expected return to voting is too low to cover even a negligible cost of voting, does not necessarily apply in Australia. Most people rightly conclude that it is easier to vote than to be harassed by the authorities for non-voting.

What makes this system even more objectionable is that the authorities also prosecute those who advocate voting in ways which the Australian Electoral Commission disapproves of. Australia's only prisoner of conscience to be recognised by Amnesty International, self-styled Maoist and anarcho-Stalinist Albert Langer, earned this status by advocating people cast their vote in a way that was otherwise valid, but prevented their preferences from being distributed (Langer has since been released).

Australia's preferential voting system is otherwise one of the best in the world and arguably raises the expected return to voting by allowing people to both better indulge their preferences and to engage in strategic voting.

The decision of disendorsed Liberal MHR Peter King to run as an independent in Wentworth increases the expected return from voting in this contest. I will be casting my primary vote for the endorsed Liberal candidate Malcolm Turnbull. Because Turnbull is likely to poll first or second on primaries, it is unlikely my preferences will be distributed, so I get to indulge my preferences without worrying too much about their implications.

Like Andrew Norton, my second preference will go to the Labor Party. Not only does the ALP have the second closest fit with my preferences, a Labor government with an absolute majority is arguably preferable to the possibility of a minority government dependent on independents for support. An ALP member would be a one-term affair in Wentworth, whereas Peter King could become an entrenched public nuisance as an independent.

The Fishing Party will get my third preference. While my interest in fishing is on a par with my interest in watching grass grow, the Fishing Party supports the rights of recreational fishers over meddlesome bureaucracy and government, which sounds like a good cause to me.

My subsequent preferences will go to independents, on the basis that someone who believes in nothing in particular is preferable to supporting parties who adhere to policies that are explicitly contrary to my own preferences. Robert Vogler lists his occupation as unemployed, so he will get my fourth preference ahead of Peter King, since he arguably needs the work more than Peter.

We then have the various nativist parties, which fall into two categories: the fluffy left and the things-that-crawl-out-from-under-rocks right. Since the Democrats are practically on the WWF's endangered species list, I will put them ahead of the Greens (the Democrats candidate is also a musician, so she doubly qualifies on a needs basis).

While not exactly unique in proposing to rob me to pay for other people's families, Family First get preferenced after the nativist left, but before the nativist right, for at least being upfront about their policies.

The dishonestly named 'No GST Party' is a One Nation front and so will get preferenced second last, ahead of the conspiracy theorists of the Citizens Electoral Council. Funnily enough, one of their conspiracy theories is that Australia is secretly run by Hayekians like me. Putting them last has the advantage of confirming them in their beliefs, so it's sort of a win-win for both of us.

posted on 20/9/2004

The Battle for Wentworth. Questions have been raised over Peter King's preference strategy following a letter he has sent to constituents saying 'the choice of your second preference is entirely yours.' The letter has been taken as a pitch for the first preference of Labor voters, with Anthony Green suggesting:

The letters would have been targeted very carefully too ... they would not have gone out to everybody.

The letter cannot have been too well targeted, since he sent one to me and I don't think anyone has ever mistaken me for a Labor voter! Even more amusing is the first part of the letter, which details his achievements while in Parliament. The sum total of these are: supported 'important community projects'; served on parliamentary committees; patron of 'a significant number of community groups.' Since these are practically ex officio responsibilities of an MHR, it is a pathetic list.

King also says 'I have always taken the opportunity to meet people at all levels across the spectrum, not just the A list elites.' Leaving aside the mixed spatial references (whoever said Rhodes scholars could write?), this is a curious pitch to be making in Australia's wealthiest electorate, where 'A-list' membership is practically the definition of an aspirational voter!

Peter King also weighs in on the really heavy issues surrounding Telstra in the latest *Wentworth Courier*. But don't go looking for his views on privatisation, etc. His sole concern with Telstra is that the latest edition of the White Pages is too heavy for old people!

posted on 18/9/2004

The *SMH* has yet to publish Alan Reynolds' reply to John Garnaut on the subject of the 1999 CGT reforms (see post from 6 September). For the benefit of IE readers, here it is:

John Garnaut offers an odd reason for declaring that "Howard's crackpot capital gains tax reforms fail" (6 September), and blames me for an estimate I never made.

Mr. Garnaut claims my "short run prognosis" said "every 1 per cent tax cut produced 1.7 per cent more transactions." My [ASX paper] showed that the lowest estimates from 11 U.S. studies averaged -0.9. That -0.9 estimate implied that halving the higher CGT rates (not the lowest rates) would not lose significant revenue, even in the long run. The Ralph Commission's -1.7 short run estimate was not from my study, but it was consistent with a 1989 study by Len Burman and others, which estimated an elasticity of -1.63.

I never suggested capital gains tax revenues would rise if stock prices fell. Yet Mr. Garnaut's only evidence of "failure" is that the amount of realized capital gains "has increased only $350 million to $6.2 billion over those three years [between the fiscal years ending in June 30, 1999 and July 1, 2003], despite strong sharemarkets." Strong? All ordinaries declined from 3258 in July 2000 to 3050 in July 2003.

That was a smaller decline than in most countries – thanks to the more attractive after-tax return on Australian stocks – but lower stock prices do not produce larger gains. For 2004, however, CGT revenue will be surprisingly strong.

Garnaut says the Ralph Commission "should have consulted" with Leonard Burman. My paper included a detailed critique of Burman's work, and that of Alan Auerbach and Jane Gravelle (consultants recruited by the Democrats). The 1994 Burman-Randolph paper covered only 1980-83. It mentioned only with the highest tax rate on capital gains, yet for all but a few taxpayers in the 70 percent bracket, the decline in tax rates amounted to only 10% in 1982, but 19% in 1983 and 24% in 1984. That provided an incentive to delay selling: Realizations were 2.7-2.9% of GDP in 1980-82, then 3.6% in 1983 and 4.2% in 1984. Burman and Randolph missed when tax rates fell, which renders their study irrelevant.

Ironically, Burman and Randolph came up with a huge short-term elasticity of -6.42 – seven times my figure. They claimed to find little "long run" impact, even though significant tax reduction actually happened in only in one year, 1983. Burman's 1999 book said "the response of individuals to permanent differences in tax rates was small or zero," but that is not what his study said. It said "long-run elasticities of 0.0 and -1.0 are both" equally likely.

In a 1997 paper, Auerbach and Jon Siegel estimated high short-term elasticity from 4.35 to -4.9 (http://www.nber.org/papers/w7532). They also found "larger permanent responses to capital gains tax rates than those of previous panel studies" – twice as large as the estimate I used. Those authors were later joined by Burman (in Joel Slemrod's book Does Atlas Shrug?) finding "tax avoidance is not prevalent."

In an earlier article (29 July), Ross Garnaut noted that the Australian economy "has performed better than that of other rich countries for the first time." The Australian stock market also performed better, even as U.S. stocks declined from March 2000 to March 2003. Australia's reinvigorated performance is something I predicted would accompany its newly competitive tax rates on successful domestic investments. I gladly accept responsibility.

Alan Reynolds
Senior Fellow, The Cato Institute
Washington D.C.

posted on 17/9/2004

An AEI-Brookings Joint Centre paper on prediction markets. The authors find that these markets perform well both absolutely and compared to relevant benchmarks. The most interesting finding is that these markets show little evidence of arbitrage opportunities, implying that they are remarkably efficient. The authors also note that the absence of restrictions on short-selling makes 'bubbles' less likely than in more traditional, regulated markets.

posted on 16/9/2004

Foreign Exchange Market Intervention and the Profits Test. The RBA has produced a discussion paper examining the profitability of its foreign exchange intervention operations as a test of their effectiveness. The idea is that if the RBA is making net profits on these operations, it must be buying low and selling high, thereby exerting a stabilising influence on the exchange rate. Milton Friedman argued long ago that speculators must exert a stabilising influenced on exchange rates to the extent that they are making a profit. Speculators who make losses do not survive to be a persistent source of instability.

There is an obvious problem with the application of this test to a central bank, because it is not a speculator in the conventional sense. The RBA trades with a risk-free capital base, has very deep pockets and is backed by a government that can ultimately socialise its losses. The RBA can thus take a much longer view in its trading than any other participants in the market, which is the key to its profitability.

But over long time horizons, official intervention is an insignificant determinant of the exchange rate under a floating exchange rate regime. Whatever influence the RBA might exert over such long horizons would be swamped by other factors. Indeed, over the post-float period, the RBA's net intervention operations have fluctuated around zero, so we would not expect them to have had any systematic effect on the exchange rate.

The stabilising properties of official intervention should only be considered at much shorter horizons, over which they have some chance of exerting an influence on market outcomes. The effectiveness of intervention at short horizons is almost entirely predicated on the ability of the central bank to introduce additional uncertainty into the market. Needless to say, this uncertainty represents a substantial additional cost to other participants in the market, makes markets less efficient and could well be destabilising rather than stabilising.

The profits test does hint at another possible, albeit unofficial, rationale for intervention: a discretionary proprietary trading operation on behalf of the government. Many a headline Commonwealth budget balance has been rescued by a well-timed RBA dividend.

posted on 14/9/2004

Action Economics Does It Again. Action Economics wins the CBS MarketWatch Forecaster of the Month for August. As CBS notes, Action Economics has dominated this award since opening for business in May. Congratulations to chief economist Mike Englund and the rest of the US team.

You can sign-up for a free trial here (use free trial code 'Institutional Economics').

posted on 11/9/2004

Liberty Bubbles. Jason Potts makes a case from an evolutionary economics perspective for the benefits of asset price 'bubbles:'

Bubbles are good for economic performance when they are the spontaneous outcome of a market process, that is, when they are real bubbles. Real bubbles concentrate an energised mass of attention and liquidity onto a hard investment coordination problem. The bubble activity generates the increased variety that lowers the costs of experimental ventures that opens new territories of forward contracts into which real investment sometimes, and more often than not, flows. Through this evolutionary mechanism, asset price bubbles lead economic growth. A bubble is good for growth because it creates a low cost environment for experimentation. The results of these experiments may continue to fuel the evolving economy for decades to come. Real bubbles cause long run growth in economic systems that can withstand them. They should be left alone to do so. This is why real liberals don't worry about real bubbles, and nor should anyone else.

Those who fret about 'bubbles' demonstrate they do not understand the role of markets as discovery processes. Asset price inflations and deflations are an inherent part of this process. Of course, not all 'bubbles' are the 'spontaneous outcome of a market process.' Many asset price booms and busts have been induced by regulatory failures of one kind or another and are far from benign in their implications. Unfortunately, the regulatory response to asset price busts more often than not inhibits rather than facilitates the market discovery process, making malignant bubbles more rather than less likely.

posted on 9/9/2004

'Bubbles' as Moral Panic. Adam Posen takes on the hellfire and brimstone economists, who see a 'bubble' lurking behind every rally and change in monetary policy:

Like the hellfire preachers of yesterday, today's economic pundits are taking a stern line on excess. Economies that enjoyed asset price booms, notably the US, are damned to pay for their wanton ways. Central banks that attempted to offset the negative effects of a bubble's burst, notably the US Federal Reserve, are merely postponing the day of judgment and, if anything, compounding their sin by blowing up other bubbles - in housing, or in government bonds, or both. The financial press is full of grim prognostications of economic damnation postponed but not avoided.

This is all pernicious nonsense. Pernicious because it discourages central banks from responsibly doing their job of stabilising the real economy, as the Fed correctly did in 2001-03. Nonsense because there is no evidence to support these claims. Bubbles have only rarely caused the lasting damage that these commentators assert as unavoidable destiny; when they have, it has been because central banks have failed to respond to the bubbles' aftermath. The outdated but apparently still widely attractive monetarist image of liquidity as toothpaste - if you squeeze the tube in one place, it bulges somewhere else - does not stand up empirically.

This image is in fact a caricature of monetarism. It actually has more in common with some of the cruder renditions of Austrian theories of the business cycle. But as Posen implies, the widespread abuse of this notion indicates that there is no real theory underpinning popular views about how monetary policy works.

posted on 8/9/2004

Alan Reynolds vs the Economic Girlie Men. Ross Gittins is on leave, but that doesn't mean we are spared the 'Girlie Men' economics. Gittins stand-in John Garnaut would have us believe that the 1999 reduction in capital gains tax was 'one of the most brazen experiments in Republican economics,' which he holds responsible for a wide-range of social and economic ills, including the recent house price boom.

Given that rapid gains in house prices have been a feature of all of the Anglo-American economies in recent years, most of which have seen no change in their capital gains tax regimes, this argument has no credibility. But that does not prevent it from being repeated ad nauseum by the likes of Garnaut and Gittins. If we accept the view that capital gains tax relief introduces a distortion into the tax system, we could just as easily single out high marginal income tax rates rather than lower rates of tax on capital gains as the source of the distortion. The distortion is one that encourages people to minimise their taxable income, not one that encourages them to seek out capital gains.

Garnaut suggests that the Australian reforms were overly influenced by an ASX commissioned study by Alan Reynolds. According to Garnaut, 'incredibly, this second class, ideological economic research quickly became entrenched in Australia's tax laws.' In fact, if Reynolds had his way, Australia would have no general capital gains tax regime, like New Zealand, Singapore and many other countries that seem to get by perfectly well without one. Reynolds does a very good job of highlighting the dubious intellectual history behind the idea that we should tax capital gains.

Putting aside the overblown rhetoric about ‘Republican economics,’ I would encourage people to read the Reynolds study and decide for themselves who is really guilty of the second-rate, ideological analysis in this debate.

posted on 6/9/2004

A Monarchist for Turnbull. Peter King, the disendorsed Liberal member for the federal seat of Wentworth (my own electorate) has announced he will contest the seat against the endorsed Liberal candidate, Malcolm Turnbull.

This comes as no surprise to those of us living in the electorate. Having been almost invisible for three years, King has been all over his constituents like a bad rash since losing preselection. He has also been busily adopting positions on Kyoto, Australia’s Gitmo detainees, refugees and the Iraq war, all of which are calculated to appeal to the local, well-heeled left. This led to an amusing moment at today’s press conference. While King burbled on about the environment, a bystander interjected ‘Where are the old growth forests in Wentworth?’ (Wentworth is Australia’s most densely populated federal electorate). Given the large number of genuine left-wingers we have to choose from in this election, it is far from clear why anyone would want to vote for a faux leftie like King.

At the same time, the versatile Mr King has staked a claim to the right-wing fogey vote by contrasting his support for the monarchy with Turnbull’s well-known republicanism. Some local monarchists, although by no means all, have declared they will not support a republican candidate. Yet in supporting Peter King, they are potentially damaging the leading anti-republican of them all, Prime Minister Howard. For die-hard monarchists to vote for King would be counter-productive to their own cause.

I also happen to be monarchist, albeit of the minimalist variety. As Chandran Kukuthas once said, the best thing about having QEII as head of state is that she lives thousands of miles away and minds her own business. Heads of state don’t come much better than that. The sad thing about the monarchist-republican debate is that it has never been about genuine constitutional issues, but a pointless culture war between two types of nationalism vying for the right to put their stamp on national symbols. The 1999 republic referendum was lost because it tried to fudge important constitutional issues in which the leading protagonists had little interest. Unfortunately, the die-hard monarchists have turned Wentworth into a proxy war against republicanism.

Peter King has sought to characterise his candidacy as a David and Goliath struggle. King is indeed a political pigmy compared to Turnbull. He has made no contribution to Australian public life in his three years in Parliament and will make even less of a contribution as an independent. In this election, there are few candidates more worthy of repudiation.

posted on 3/9/2004

Faux Globalisers. This blog has often been critical of Martin Wolf and Jagdish Bhagwati for conceding too much to globalisation's critics. The AEI's Roger Bate makes similar points:

But even Wolf concedes ground to the forces opposing economic liberalisation, while supposedly market-oriented academic economists like Jagdish Bhagwati (In Defence of Globalisation, Oxford University Press) accept whole swathes of the arguments promoted by the opponents of globalisation.

The result is a continued advance of the forces of protectionism and stagnation while at the same time market liberalising globalisation is benefiting more and more around the planet...

For someone who has written so persuasively about the need for private sector involvement in both health and education it does appear that Wolf's courage has failed him. The result is that even the best, most informed and mainstream defender of globalisation provides support for government expansion.

That is a pity because globalisation through international trade has done more to increase health, education and remove poverty than any government programme.

posted on 2/9/2004

It's the Economy, Stupid. Notwithstanding the government's emphasis on its economic record, the economy is the most underrated factor in the current federal election campaign. With the unemployment rate at multi-decade lows and with growth in domestic final demand running at a stunning 6.4% in the year to June, the current macroeconomic environment could not be more favourable to an incumbent government going into an election campaign. In the absence of any obvious overriding negatives, it would be quite stunning for the government to be defeated in this context.

The Cameron and Crosby (2000) model of the incumbent two-party preferred vote share suggests that a one percentage point increase in the inflation rate subtracts 0.42 percentage points, while a one percentage point increase in the unemployment rate subtracts 0.29 percentage points from the incumbent's vote share. The unemployment rate is one percentage point lower now than at the time of the 2001 federal election, while the inflation rate is currently 2.5% compared to 3.1% at the time of the last election.

As usual, the federal parliamentary press gallery remains fixated on non-substantive issues, while the two major parties have fully endogenised each other's policies and the preferences of the median voter. While I still incline to a random walk interpretation of election outcomes, if there is a deterministic component to the two-party preferred vote linked to the economy, then the opposition was arguably buried before the campaign even began. Even the Democrats-Greens scare campaign about a Coalition majority in the Senate starts to look plausible.

Against this background, The Economist's Global Agenda section asserts:

whoever wins the election on October 9th will inherit an economy whose foundations appear increasingly precarious. If the housing boom comes to an *end, consumer spending will most likely collapse.*

It is not hard to see why *The Economist's* stringers are kept anonymous, when they pass off simplistic rubbish like this as analysis.

UPDATE: Arnold Schwarzenegger puts it in terms even *The Economist* can understand: *Don't be economic girlie men!*

posted on 1/9/2004

Central banks have a nasty historical record of debasing national currencies. The Reserve Bank of Australia has diversified into debasing loyalty program points:

In a letter to its Altitude card holders, Westpac has advised of a "repricing" by which the value of points earned has been devalued by 12 per cent…The bank has also disallowed BPay credit card bill payments from being eligible for points… Cards consultant Mike Ebstein said the RBA reforms so far had resulted in higher annual card fees and lower rewards, especially with frequent flyer points. In March, Westpac doubled the spending required to earn one frequent flyer reward point. "You have to spend more on average to get a point and you can do less with it," Mr Ebstein said. "It is the inevitable result of the reforms where the loser has been the customer, with the blessing of the RBA."

The RBA claims to be increasing the efficiency of the payments system, but it is fairly clear the banks are by-passing the reforms and retailers are not passing on any savings in terms of prices. A cheeky public choice interpretation of the RBA's reforms is that the RBA wants to promote the use of cash and cheques because it derives seignorage and other revenue streams from these payment methods. Such profit-seeking behaviour is also evident in its foreign exchange intervention operations, the frequency of which cannot be rationalised in terms of 'smoothing' the market and look increasingly like a proprietary trading operation.

posted on 31/8/2004

Post-Traumatic Howard Derangement Syndrome. AEI scholar Michael Novak recently speculated about the how the left would cope with a Bush victory in November (short answer: badly). This is perhaps an even more relevant question in the context of Australia's federal election on 9 October. Notwithstanding Novak's view that a Bush victory is practically preordained by God*, a secular case could be made that JWH is in a much stronger electoral position than GWB.

A JWH victory would induce such profound cognitive dissonance in the local left as to almost constitute an argument for voting Coalition in and of itself. Rationalising defeat could only intensify the nation-wide mental health contagion known as Howard Derangement Syndrome into a new, post-traumatic manifestation.

The contrast with my many friends on the right could not be starker. Almost all of them are fairly relaxed about the possibility of a Mark Latham victory. The left are so obsessed with demonising JWH, they have somehow overlooked the fact that implicit in Mark Latham's election platform is a fiscal austerity program that would shame John Hewson's 1993 Fightback manifesto. A mad-as-hell social democratic reformer having his legislation rubber-stamped by the Coalition in the Senate, leaving the nativist bloc out in the cold, is something most of us could live with. As always, the right simply have a much better sense of perspective.

Conventional wisdom holds that long campaigns favour the opposition, but I suspect this wisdom is about to be turned on its head. Latham has already shown an inability to withstand even moderate pressure or critical scrutiny and this will likely prove fatal in a campaign context.

Centrebet has the Coalition at 1.55 and Labor at 2.55. It might also pay to go long pharmaceutical stocks on demand for anti-depressants from the left post-October 9.

* P J O'Rourke famously argued that God was a Republican, Santa Claus a Democrat.

UPDATE: John Quiggin is offering a (yet to be revealed) prize for the best forecast of the number of the Coalition seats won. My forecast is for 83 seats (ie, random walk around the notional number of seats currently held by the Coalition).

posted on 29/8/2004

The Current Account Deficit and Housing Credit as Moral Panic. Current account deficit angst and concerns over housing-related private sector credit growth are perhaps classic examples of moral panic. The moral panic is occasioned by the view that countries or households are 'living beyond their means.' Market-determined borrowing and lending decisions should rarely give rise to concerns on this score, unless one can make an argument for some pervasive imperfection or systemic failure in capital markets. There may in fact be some significant regulatory inducements to inappropriate borrowing or lending behaviour. The role of Basle capital adequacy requirements in the Asian crisis for example, or the many historical banking and financial crises induced by regulatory failure or capture in the financial sector are obvious examples. Even then, market-determined exchange rates can help undo much of the subsequent damage. Yet most of the angst on these issues is generated by capitalist acts between consenting adults rather than regulatory failures which are potentially far more damaging.

The notion that domestic demand should be constrained by domestic production is increasingly anachronistic in a globalised world. While many people grasp the welfare-enhancing nature of trade in goods and services, it seems that few can fathom that the same principles apply to global trade in capital and labour. This is not surprising, given that hostility to cross-border flows of capital and labour is even more pervasive than hostility to free trade in goods and services. In part, this may simply be due to lack of recent experience. International capital and labour mobility is much lower today that in the late 19th century, despite all the talk about globalisation. Singapore provides a good example of a country that is very open to trade in goods and services, but relatively closed to foreign capital through capital account restrictions and the failure to internationalise its currency. The moral panic over current account deficits is thus partly symptomatic of a closed economy mindset. It is this mindset that is far more dangerous than current account deficits.

posted on 27/8/2004

RBA Governor Ian Macfarlane talks about the long-run determinants of economic growth, including a refreshing focus on the importance of 'deep' institutions. Macfarlane is something of an economic history buff and it shows in many of his speeches. This also comes in handy on those many occasions (including this one, apparently) when he wants to say absolutely nothing about his day job, namely monetary policy.

There is a certain irony in Macfarlane's speech when he argues for 'constraints on the ability of government or other elites to exercise arbitrary power.' The same could be said of the need for constraints on the powers of central bankers. This is the thrust of those of us who argue for the importance of central bank reform. The RBA shares with the US Fed the dubious honour of running one of the least rule-bound approaches to monetary policy in the developed world.

posted on 25/8/2004

The Workers' Party Rides Again. A number of libertarian independents will be running in NSW in the upcoming federal election. As best as I can recall, this will be the first time libertarians have run at a federal level since the (ironically named) Workers' Party in the 1970s, so it will be an interesting experiment. One of the joys of our preferential voting system is that you can express support for these candidates, while still directing your preferences to the major party of your choice.

While wishing them every success, I suspect they have an uphill battle ahead of them. Libertarianism is not a strong tradition in Australian public life. Even in the US, the Libertarian Party has struggled, although this is probably due to being captured by the 'tinfoil hat' brigade. Since these candidates are running as independents, rather than under the name of a registered 'libertarian' party, their vote probably won't be a good reflection of whatever underlying support there might be for libertarian ideas. It is probably just as well they have not federally registered their ACT name of 'Liberal Democratic Party,' since this is more commonly associated with state-socialism in Japan than libertarianism in Australia. If you want to capture the libertarian vote, it is probably a good idea to be recognisable as such!

posted on 25/8/2004

Why the growing US current account deficit doesn't matter. Further to the debate at Quiggin, Gallagher and this blog, the Australian Treasury has published a paper on the subject in its latest *Economic Roundup*. It considers the implications of the US running a current account deficit of 5% of GDP for the next 10 years. Alan Wood summarises the argument in an op-ed:

Even if we assume foreign central banks stop accumulating US assets, Gruen and Harris believe private investors in the developed world's economies outside the US can comfortably finance its current account deficit "for an extended period".

The main reason for this conclusion is that holdings of US assets in private sector portfolios in OECD countries other than the US are not particularly big, even after allowing for the fact investors have a preference for holding domestic assets over foreign ones. In fact, other studies suggest non-US investors are underweight in US assets.

Even assuming all the financing of the US current account deficit over the next 10 years has to be done by these private investors, their holdings of US assets would only amount to 11.2 per cent of their net financial wealth, or 8.3 per cent of their total wealth.

Gruen and Harris think this is entirely plausible, particularly as their assumptions almost certainly result in these figures being overstated. But these adjustments could come at a price -- lower US growth and higher interest rates.

Gruen and Harris don't think they will, and this is where Australia's experience over the past decade or so is relevant. At the end of the 1980s, after a decade when Australia's current account deficit averaged 4.5 per cent of GDP, the deficit and the associated rise in the level of foreign debt were seen as the most serious economic problem facing Australia.

Over the 14 years since, the current account deficit has averaged only a slightly smaller 4.25 per cent, yet Australia's economic performance has been impressive by OECD standards.

The authors are much less sanguine on the question of the budget deficit, but we do not need to invoke the current account deficit to take a critical view of US fiscal policy, particularly the unconstrained growth in non-defence discretionary outlays.

posted on 24/8/2004

Anecdote as the Singular of Data. With the unemployment rate at more than 20 year lows, it is not surprising to see so many 'help wanted' signs going up in stores around Sydney, reminiscent of US cities in the late 1990s. No doubt members of the RBA Board are observing this too.

This is also a much underrated factor in the forthcoming federal election, especially given the commentariat's determination to re-live the 2001 poll. John Quiggin, for example, neglects to mention this traditional social democratic concern in his pre-election analysis.

posted on 23/8/2004

John Edwards pours some much needed cold water on the notion of a housing ‘bubble’ that has so preoccupied the RBA and the local economic commentariat:

Australia's unflustered exit from a long house-price boom is not surprising. In spite of concerns expressed by both the central bank and the treasurer, there has been little evidence over the past decade that higher household wealth has driven domestic household consumption or that rapid credit growth has facilitated it. As a share of nominal gross domestic product, nominal household consumption held quite steady while house prices were rapidly increasing. Although considerable equity has been withdrawn from the housing market, much of it is accounted for by older Australians trading down and using the difference to buy a pension. If consumption was not tied to house-price inflation and credit growth on the way up, there is no powerful reason to expect it to be tied on the way down...

Nor is the sharp drop in residential property transactions or the arrest of nominal price inflation very surprising. This is exactly the way the Australian housing market has behaved in the past, as it has in the US and the UK. When interest rates increase and expected house-price inflation slows, homeowners have reason to stay put. House prices stop going up, but do not fall. With employment and incomes increasing and mortgage rates still close to the average of the past six years, it would be puzzling if Australian house prices fell enough to threaten a more general downturn.

As we have argued previously, much of the suspicion directed at house price inflation stems from two sources: the mistaken view that housing is somehow an ‘unproductive’ asset; and the traditional animus against wealth not acquired through physical labour (ie, capital gains). The coming spring auction season in Sydney will be an interesting test.

posted on 23/8/2004

Paul Kelly discusses the politics of welfare reform, referencing Peter Saunders’ (CIS) book, *Australia's Welfare Habit and How to Kick It*:

He points out that in 1965 only 3 per cent of working-age adults depended on welfare payments as their main or sole source of income. That figure now is about 16 per cent or one in six. In the 1960s there were 22 people in work to support each working-age person living on benefits and that dependency ratio has deteriorated to just one in five.

These figures do not include family payments. They mainly constitute three groups: the unemployed (costing $5 billion a year), disability support recipients ($6.4 billion) and payments for single parents ($5.6 billion). About 14per cent of working-age Australians receive one of these benefits.

In other CIS news, Andrew Norton gets booed by 400 angry women to win the political incorrectness equivalent of Olympic Gold. Well done Andrew!

posted on 21/8/2004

Marcus Noland highlights some interesting results from the Pew Global Attitudes Project:

Perhaps the most surprising result is that attitudes towards homosexuality are highly correlated with economically relevant phenomena such as the ability to attract foreign investment and the level of sovereign bond ratings. The cross-national divergence on this issue is enormous, with 83 per cent of Czechs and Germans supporting societal acceptance of homosexuality, more than 90 per cent of the respondents in six countries opposing it, and three governments - China, Egypt and Tanzania - not even permitting the question to be asked.

The statistical correlation between tolerance of homosexuality and better than expected economic performance echoes similar results obtained previously for US cities, where a higher homosexual share of the population is associated with more high-technology activity. The question is why?

In both the US and international data, there is a correlation between acceptance of homosexuality and other characteristics such as acceptance of immigrants and the absence of a desire to protect traditional culture, which in turn are correlated with improved economic performance. It could be that attitudes toward homosexuality are part of a broader package of social attitudes towards difference and change, especially change that comes from non-traditional sources.

posted on 19/8/2004

Martin Wolf argues:

The US is now on the comfortable path to ruin. It is being driven along a road of ever rising deficits and debt, both external and fiscal, that risk destroying the country's credit and the global role of its currency. It is also, not coincidentally, likely to generate an unmanageable increase in US protectionism. Worse, the longer the process continues, the bigger the ultimate shock to the dollar and levels of domestic real spending will have to be. Unless trends change, 10 years from now the US will have fiscal debt and external liabilities that are both over 100 per cent of GDP. It will have lost control over its economic fate.

It is amusing that the projections for the deficit on the net income balance that Wolf considers so alarming for the US are fairly normal for Australia. Of course, there are some people who make similar claims about Australia's external position.

Those who peddle this nonsense should spell out what sort of current account balance they think would be appropriate for a country like the US and to distinguish between the cyclical and structural components. The last time the US current account deficit narrowed was in the depths of the 2001 recession. Wolf seems to be implying that the US should go so far as to become a net exporter (at least, that is the argument of the research on which he relies). But having a saving-investment balance that looks like Japan or Germany also implies sharing with those countries a low potential growth rate.

As for protectionist sentiment, it is just as likely to be encouraged by the alarmism of Wolf and others.

posted on 18/8/2004

Social Democrats as Social Conservatives. Fresh from supporting the government's legislation to ban gay marriage, the Australian Labor Party are now said to be entertaining Australia Institute proposals to censor the internet (in the name of child protection, of course). This might be nothing more than 'motherhood' strategic behaviour on the part of the ALP, consistent with the theory of the median voter. To some extent, it might also reflect genuine social conservatism on the part of the ALP's right-wing Catholic base (distinct from the Australia Institute's communitarian wowserism). However, together with the ALP's me-tooism on asylum-seekers, it does not say much for the ALP as a repository of progressive values. The strong two-party partisanship displayed by many of the government's opponents is very difficult to rationalise in this context, being way out of proportion with any genuine policy differences on the part of the two major parties.

UPDATE: The Australia Institute's Clive Hamilton claims:

The only groups opposed to regulating internet porn in the same way we regulate video porn are the internet industry…and a handful of retro-libertarians who maintain that porn is playful and liberating. Lacking all discernment, the libertarians cannot distinguish erotica from the dark imagery that haunts the internet.

How fortunate we are to have Commissar Hamilton to make the distinction for us. (As for 'retro-libertarian,' that actually sounds kind of cool.)

Pro-porn academics are taking on the social conservatives of the left.

posted on 16/8/2004

PWC's econometric model of Olympic medal performance forecasts Australia collecting 41 medals in Athens, down on the 58 obtained in Sydney, leaving Australia ranked fifth overall.

posted on 14/8/2004

The Kerry Effect on Stock Prices. An AEI scholar observes that the S&P 500 is negatively correlated with the implied probability of a Kerry victory on the IEM:

When the expected vote share rises and thus the implied probability of Sen. Kerry winning the election increases, the S&P 500 index tends to decline sharply. The pattern is consistent and significant. Given the negative response of the stock market index to increases in his electoral prospects, this suggests that a Kerry victory, or its inevitability in the run-up to the election, could cause a significant stock market decline. The correlation is apparent even when the lackluster response to Sen. Kerry and the Democratic convention depressed the value of the Kerry futures contract, and the stock market simultaneously rallied.

The stock market is affected by factors other than the upcoming election, and one might argue that the stock market is responding only to economic news and that the correlation of stock prices with the probability of Sen. Kerry's election is a mere coincidence. However, the economic news has been generally upbeat in *the first half of 2004 with real GDP expanding at 3.8% clip, real business investment spending growing even faster at a 12.5% annual rate, more than one million new jobs created this year, consumer confidence generally rising, and strong growth in corporate profits. While the data have flagged a little recently, there is no obvious link between economic news releases and the implied probability of a Kerry victory in the Iowa Electronic Market futures prices.*

Candidates always claim that their policies will improve economic outcomes if they are elected. Financial market developments have advanced enough that we can now evaluate what the markets think about a candidate's promises. If equity markets had a vote, it seems they would cast it for President Bush.

Needless to say, I'm not entirely persuaded by this analysis, but it's an interesting observation. A Granger causality test might make this a little more convincing.

posted on 13/8/2004

Peter Hartcher, author of (yet another) forthcoming book on Alan Greenspan titled *Bubble Man*, argues that:

In the following three years the bubble bloated to become, in proportion to the US economy, more than twice the size of the one that had preceded the Great Crash of 1929. When it burst, Mr Greenspan had to take extraordinary measures. His recovery plan took rates so low for so long that America's conventional monetary policy options now approach the point of exhaustion. The problem Mr Greenspan is trying to solve is one of his own making.

There are many arguments that could be leveled against this view, not least being that there is a lot of evidence that taking an activist approach to asset prices via monetary policy would be a disaster. More fundamentally, it is a view that attributes far too much importance to monetary policy.

It is not hard to see why Hartcher would fall into this common journalistic trap. The US has a largely discretionary monetary policy regime, under which Greenspan has assumed enormous influence over decision-making. The media preoccupation with personalities over processes makes the Greenspan Fed a natural focus of attention and explains why so many books have been written about this period (see the Reviews section for two of these).

But assuming that Hartcher is right, what does this imply about monetary policy? It manifestly *does not* imply that the Fed should be even more activist on asset prices, as Hartcher has suggested on a previous occasion, because Greenspan's experience highlights the dangers of discretionary policy. Instead, it argues for the importance of a rule-bound monetary policy regime that is largely neutral with respect to real activity and asset price determination. This would be enormously boring for journalists and consequently, as with all the other books on the Greenspan and the 'bubble' era, we are unlikely to see any constructive proposals for reform from journalists on this subject.

I should add that Hartcher's *The Ministry*, on the Japanese Ministry of Finance, is highly commendable.

posted on 10/8/2004

The Asian Shadow Financial Regulatory Committee is 'a group of independent experts on economic policy issues relevant to financial markets and the financial industry of the Asia-Pacific region.' The Committee is one of several regional committees under the auspices of the AEI. The name is reminiscent of the Shadow Open Market Committee, which for many years has provided critical commentary on the policy actions of the Fed.

The two co-founders of ASFRC have an op-ed in the *FT* which makes the argument that efforts at promoting regional financial integration in East Asia should take a back seat to integrating regional financial markets into the world economy. The authors argue, for example, that:

The push to create a sheltered regional bond market for Asia is understandable but misguided.

Having worked in financial markets in Asia in the aftermath of the 1997-98 emerging markets crisis, I was struck by the protectionist and misguided nature of the post-crisis regional integration agenda. Many of the attempts at enhancing regional financial architecture had a 'Fortress Asia' character, whereby regional authorities sought to harness the massive foreign exchange reserves the Japan and China into bilateral swap arrangements, measures that were at best irrelevant and at worst dangerous. The post-crisis regional reform agenda was partly hijacked by Japan, which saw an opportunity to promote its long-standing and misguided campaign to 'internationalise' the yen.

What was perhaps most distressing about all this was the active encouragement of Australian policymakers, breaking ranks from the more skeptical views being sounded by the rest of the Anglo-American international economic policymaking community on many of these issues.

posted on 6/8/2004

Australia-US FTA Stalemate. Kim Weatherall points to some of the problems with the opposition's proposed amendments:

I think there's plenty wrong with the Implementation Bill, and Chapter 17 in general, but I don't think that patent evergreening is really likely to be one of the problems, given the legislation. Just look at how the Generics Industry has reacted. It's a real shame that Latham is planning to fight like a Kilkenny Cat - over nothing.

Peter Gallagher argues that the deadlock is a triumph of political product differentiation over legislative necessity:

The pity of this debate is that the apparent fault in the Agreement does not need to be solved now in an amendment to the FTA implementing legislation. The legislation can safely be passed now, bringing the Agreement into force next year, after the election. There will be ample time then to consider a proper approach to the resolution of the underlying issue based on a more thoughtful amendment to the patents legislation addressing the issue of "evergreening", which clearly goes much wider than the FTA with the United States.

After all, there are large European drugs companies who are equally aggressive *patenters of drugs and who also supply the PBS.*

Presumably, evergreening is also a means that the European firms may use to minimize the price-impact of generics. The only difference between the European and US firms, as far as I can see, is the 'prior notice' aspect of the FTA. But that's a comparatively trivial issue.

Unfortunately, both Labor and the Conservatives seem bent on proving that they hold political product differentiation a higher good than adopting a treaty that each agrees is in the national interest.

But let us not forget that the need for product differentiation has arisen first and foremost from the ALP's internal divisions on the FTA.

posted on 5/8/2004

A Global Currency. I'm not a big fan of Martin Wolf and even less so having read his latest piece advocating a global currency. Wolf's argument is that currency volatility makes emerging market debt financing too dangerous and encourages global imbalances. This actually confuses cause and effect, a common mistake on the part of those who do not understand the role of exchange rates.

The proposed solution is something far more scary than mere exchange rate volatility, entailing a global one-size-fits-all monetary policy. The euro zone already illustrates why this is a bad idea. Putting the money supply in the hands of a central planner is tolerable at a national and even supra-national level, partly because market-determined exchange rates provide an important check on the actions of national monetary authorities. Many of the recent fluctuations in the euro, for example, represent the market's attempt to offset the actions of the ECB. There is no such check on a global currency.

As Samuel Brittan has argued, we need more currency competition, not less. I have long favoured the Black-Fama-Hall system advocated by Greenfield and Yeager, which argues for the separation of the medium of exchange from the unit of account. The latter could well converge on a global standard, while still allowing competition in the former. Multiple privately-issued media of exchange would trade freely at market-determined exchange rates, with arbitrage within an asset and commodity bundle defining the unit of account serving as the nominal anchor.

It is amazing the extent to which those who readily accept arguments for competition in the supply of goods are all too ready to accept central planning in relation to money. Indeed, government involvement in the monopoly supply of goods and services is relatively harmless compared to its historical role in the supply of money.

posted on 4/8/2004

All His Own Work. The federal parliamentary Labor caucus is set to fall in behind the Australia-US FTA. It is remarkable how Labor leader Mark Latham allowed himself to be boxed into a position where he would be damned by whatever decision he took. John Quiggin argues that Latham should have opposed the agreement, but this would have been even more disastrous for Latham than mere indecision. Quiggin is now predicting a Coalition victory in the coming federal election. It is hard not to attribute the Coalition's lift in today's Newspoll to Latham's ineptitude. The looming challenge for the left will be to rationalise defeat when the issues cycle has been so favourable and without a single Norwegian freighter in sight.

UPDATE: Labor's support for the FTA has been made conditional on acceptance of two amendments in relation to the PBS and local content. The government has caved on the latter, although the real capitulation to the cultural protectionists took place long ago. The government is resisting on the PBS, so the FTA now hangs on political brinksmanship.

The commentariat are reluctant to commit on whether this is an act of political genius on the part of Latham, or whether he is just digging himself a bigger hole. Latham has arguably handed the government a bigger stick with which to beat the opposition. The government has more credibility on the FTA than Labor. Making the FTA an election issue would keep the political agenda on ground more favourable to the government and prevents Latham from hiding behind motherhood social issues.

It's going to be an interesting election afterall.

posted on 3/8/2004

The anti-free trade elements of the trade union movement commissioned Peter Brain to do modelling of the Australia-US FTA. Glenn Milne gives an overview of Alan Oxley's counter-arguments on behalf of AUSTA. Brain is perhaps best known for his regular predictions of a recession or depression for the Australian economy, nicely illustrating the old joke about correctly predicting ten of the last two recessions. Given that the Australian economy has recorded one of its longest expansions and one of the strongest growth rates in the OECD throughout the 1990s-2000s, Brain's cumulative forecasting record leaves much to be desired. Of course, eventually we will see another recession, and Peter will be there to say 'I told you so.' Those suspicious of alleged 'knowledge spillovers' will not be surprised to learn that they feature in Brain's modelling.

posted on 2/8/2004

Clueless and Lazy Pundits. The ABC's weekly *Insiders* program assembles a panel of pundits for their take on politics. This morning's panel would have us believe that no reliable polling has been conducted on the Australia-US FTA. There has in fact been considerable polling on this issue and some insightful analysis of the poll results (see previous posts). Is it too much to ask that the federal parliamentary press gallery back their punditry with a little research? So much for keeping their fingers on the political pulse.

Not so long ago, I was appalled to read a newspaper story that could best be described as a politically-motivated hatchet job. But what appalled me most was the fact that it was such a *badly researched* hatchet job. The most basic research in the newspaper's own archives would have turned up a far bigger and more damning story than the material included in the article (which was most likely provided to the journalist by someone else).

posted on 1/8/2004

Samuel Brittan discusses Robert Gordon's work on income differences between the US and Europe:

European output per hour is now 93 per cent of that in the US while output per capita is a much lower 77 per cent. The difference between the two measures is attributable to longer hours in the US, to lower unemployment there and to higher labour force participation. If the differences merely reflected a European preference for leisure or early retirement by individual citizens, there would be nothing to complain about. Prof Gordon's guess is that a third of the difference reflects voluntarily chosen leisure and the remaining two-thirds reflects laws and practices that have priced European workers out of the labour market.

When Prof Gordon turns from crude GDP to welfare, he is not so sure. He suggests that not all the higher US GDP is welfare-enhancing. Some of it involves fighting the environment: for instance, heating and air conditioning to combat a more extreme climate. Some of it, too, goes on a higher level of home and business security to protect against crime or to maintain 2m people in prison. He speculates that the Europe/US economic gap might well be reversed by a broader welfare measure.

OECD economists discuss that hardy perennial, alleged US over-consumption. Part of their conclusions:

Taking stock of the available evidence, there does not seem to be a case of autonomous overconsumption in the late 90s and early 2000s. What we have been seeing instead is a flexible and welfare-enhancing adaptation to a foreign saving shock motivated by higher expected returns in the US.

posted on 31/7/2004

Inflation and Interest Rate Sentiment. My take on this week's CPI outcome and current interest rate sentiment over at Action Economics:

We can only take so much comfort from current inflation outcomes and the RBA's benign inflation forecast. Under an inflation targeting regime, inflation should be an endogenous variable. Inflation outcomes within the target range tell us no more than that the RBA was doing its job properly 12-18 months ago. The main interest in the CPI should be as a baseline for the inflation outlook.

Similarly, the RBA's inflation forecasts should not be independent of its policy actions. The Reserve Bank of New Zealand makes this explicit, by forecasting a path for interest rates it thinks will be consistent with maintaining inflation in the target range. RBNZ policy actions are carefully rationalised within this framework. The RBA, by contrast, persists in presenting the inflation outlook as though it were an exogenous variable. While we can identify various exogenous influences on inflation that might impact the inflation forecast, the RBA's job, except in the case of major shocks, is to conduct policy in such a way as to keep inflation in the target range. The RBA's inflation forecasts are subject to other technical forecasting assumptions, such as a steady exchange rate, which are unlikely to fully reflect its assessment of the risks to the inflation outlook.

So while both inflation and the RBA's official inflation forecast remain benign, we are still left with the task of forecasting the path for interest rates that is consistent with maintaining this benign outlook. The question for policymakers and markets is whether the current broadly neutral stance of policy is consistent with continued low inflation.

posted on 30/7/2004

Richard Epstein on cartels and anti-trust:

In this new non-Euclidian world of potential liability, harm to competitors is no longer treated as a sure sign that market processes have weeded out inefficient competitors. Now a low cost for goods becomes a form of predation, the language here suggesting that a company that goes after another is like a wolf that chases a rabbit. Low costs, or zero costs, which provide immediate short-term benefit for consumers, are treated as though they hold a long-term peril to our general economic well-being. The upshot is that we develop fine-spun theories to explain why Microsoft has committed some ultimate market sin by securing a prominent place for its Internet Explorer icon on its desktop. All this is not to say that there is not some place for state intervention in network industries, because mandated interconnections on non-discriminatory terms seem to be as important here as they are in telecommunications and transport. But once we get beyond that important set of obligations, then the relentless application of the antitrust laws will sap the vitality of the very competition that these laws are supposed to preserve.

Graeme Samuels, take note.

posted on 29/7/2004

Alan Reynolds on the budget deficit forecasting cycle:

Many professional deficit hawks will spend the next year or two telling us the sky is falling, as they did in 1985 and 1995. Private researchers may be "independent," but not disinterested. Those of us who are eager to roll back the runaway federal gravy train have an incentive to exaggerate future budget deficits, even though we know very well it is the spending itself rather how it is financed that matters most.

Those who want to increase taxes (at all times and for any conceivable reason) have even more incentive to exaggerate future budget deficits, because spending cuts take booty from their most bountiful constituents, which explains why such cuts are termed "unrealistic."

posted on 28/7/2004

John Quiggin is pleasantly surprised by the Greens economic platform. Quiggin is right to suggest that we should take the policies of minor parties seriously in the sense of subjecting them to critical scrutiny and holding them accountable for their policy positions. Minor parties too often adopt positions of 'all care, no responsibility,' with the result that they are held to a lower standard than the major parties.

One of the great contributions of former Labor Finance Minister Peter Walsh was to actually do costings of the policies of some of the minor parties. Some of the resulting op-eds, castigating the then Democrats leader as the 'Eva Perron of Australian politics,' for example, were truly memorable.

What strikes me most about the Greens' policies is their similarity to those of One Nation (to the extent that we could ever identify coherent policies on the part of the latter). There is a common theme of hostility to globalisation and its consequences and the desire to adopt isolationist and interventionist policies in response. Both are hostile to immigration and advocates of population policies, even if for somewhat different reasons. The Greens, Democrats and One Nation are perhaps best characterised as 'nativist' in philosophy. Historically, this perspective was closely associated with the White Australia policy. While the explicit racism is gone, the residual xenophobia remains alive and well. There is also a notable 'cycling' in the primary vote of the nativist bloc, suggesting that the minor parties are largely in competition with each other for the anti-globaliation vote, rather than with the major parties.

Fortunately, the two major parties have for most part embraced openness and rejected the backward-looking parochialism, protectionism and isolationism that characterises the fringes of Australian politics.

posted on 27/7/2004

The Vast Left-Wing Conspiracy. The *NYT* profiles the efforts of various well-heeled benefactors of the left in the US to match the right in terms of fund raising, organisation and intellectual capital generation. I would argue that the left is weakest in relation to the latter, as the following quote from the article demonstrates:

"Now, you're a 32-year-old Democratic state legislator, and what you do is you learn how to check boxes," he continued. "You learn how to become pro-choice. You learn how to become pro-labor. You learn how to become pro-trial lawyer. You learn how to become pro-environment. And you end up, in that process, with no broad philosophical basis. You end up with no ideas about national security. You end up with no ideas about American history and political theory. You end up, frankly, with no ideas about macroeconomics and economic policy, other than that it's scary."

This is an interesting admission, not least because it implies that many of these policy positions are held more as a matter of convenience than belief. A mistaken assumption underlying these efforts is that money alone can buy success for ideas. It can certainly help with promotion, but the ideas themselves must stand or fall on their merits. The post-war revival of classical liberalism was first and foremost an intellectual phenomenon. The money and organisation flowed later, but has always been tiny compared to the enormous resources arrayed against classical liberal ideas. It was the relevance of these ideas to contemporary problems that bought them the most currency.

Soros and Co. still have things backwards.

posted on 26/7/2004

Henry Farrell and Dan Drezner have co-authored a paper on the role of blogs in US politics. From an Australian perspective, I think the main potential contribution of blogging (and the internet in general) is to break-down the insularity, protectionism and parochialism that has historically been a problem in Australian public life and discourse. The potential for disintermediation of Australia's heavily regulated mainstream media is considerable. The fact that many of the technological barriers to entry in the industry have fallen to almost zero undermines the traditional rationales usually offered to disguise the rent-seeking and protectionism that is the real basis for media regulation in Australia. This is not to say that there are not other powerful barriers to entry. The government is doing its best to regulate new technologies for the benefit of incumbents. However, the experience of bloggers in the US gives grounds for optimism.

The post of Washington correspondent has long been considered the high point of an Australian journalistic career and usually a stepping stone to the job of editor of a major broadsheet. This role is now surely redundant. The two most recent Washington correspondents for the *AFR*, for example, have relied heavily, with attribution, on readily accessible US publications, as well as the *Cook Political Report*, the *Washington Monthly* and *Grant's Interest Rate Observer*. One even went through a phase of framing his stories in terms of what was on the late night US talk shows, which have long been shown on Australian television. In the absence of any other value-added, the days of the Australian Washington correspondent are surely numbered.

Another media institution that is ripe for disintermediation is the federal parliamentary press gallery. When I worked in federal politics, the gallery were the last place you would turn to for insightful or objective analysis. Members of the gallery were just assumed to be players in the process and their output was treated accordingly. The gallery no longer has the same advantages in terms of access to information, but still has all the disadvantages of being heavily process-driven and manipulated. The US experience with blogging suggests that political punditry in Australia is potentially wide open to competition, even though no obvious competitors have emerged as yet.

Institutional inertia and the best efforts of government regulation suggest that these roles will not be transformed in an obvious way in the immediate future. But their growing irrelevance is readily apparent. There is enormous potential for new media entrepreneurs to reinvent these established media roles. The blogging phenomenon in the US serves to highlight the possibilities.

posted on 23/7/2004

Tax Trap. Andrew Norton's monograph on public opinion on taxing and spending is out, with an op-ed version here. Norton suggests that the apparent increase in public support for government spending reflects a combination of the economic cycle and a tax trap:

When people are best able to afford private alternatives, when they are prosperous, they are most likely to want to spend more on government services. One reason for this is that voters are in a tax trap. They cannot switch to private-sector health and education except by paying twice, once through their taxes, and again through private health and school fees. Though they may prefer to go private, a modest tax increase seems a cheaper way of improving services when they cannot get their tax back.

posted on 22/7/2004

Private Preferences and Public Prejudice. Robert Gottliebsen makes the argument that a renewed resurgence in house prices, driven by supply-side constraints, is set to trigger an aggressive interest rate response by the RBA:

Macfarlane believes that Australian house prices are too high relative to the rest of the world and he is determined that they should not have another big short-term increase.

I agree that one of the reasons we are unlikely to see a major collapse in house prices is because of a host of supply-side problems that are capitalised into house prices. Unlike Gottliebsen, I do not think that household credit and house prices are the major driver of monetary policy. The RBA's actions can be easily rationalised with respect to the inflation and growth outlook.

Yet monetary policy depends crucially on central bank communication with the public and managing expectations. Most of the country's economic commentators and market economists are now talking about monetary policy almost exclusively in terms of household credit growth and house prices, even to the point of assuming that the RBA has implicit targets for both.

The RBA is not meant to be in the business of targeting asset prices or capitalist acts between consenting adults, but it is not hard to see how the RBA's pronouncements on these issues could lead people to this conclusion. Unfortunately, this sort of confusion is an all too predictable result of Australia's failure to take central bank reform seriously (see my review of Stephen Bell's book on the RBA in the Reviews section for further elaboration of this view).

Assuming the commentators are right and the RBA is now in the business of targeting credit growth and house prices, then we risk seeing a serious clash of RBA prejudices with household preferences. The RBA has yet to come to terms with the innovations in financial technology which allow households to alter their balance sheets by accessing home equity. The RBA assumes it knows better than households what private debt levels should look like.

If all this sounds familiar, it should. A similar clash of private preferences and public prejudice occurred in the late 1980s, when the RBA and Treasury thought they knew better than households what Australia's current account balance should look like. The results were disastrous. Yet as Alan Wood argues, this view remain alive and kicking:

A view gaining ground is that our large current account deficit (now about 6 per cent of GDP) and high foreign debt are unsustainable. Far too much borrowing has been done to finance a boom in housing investment and consumption and soon there will be a day of reckoning with the foreign investors who have provided most of the money.

Wood goes on to argue why this should not necessitate a recession. All of which suggests that macroeconomic policy may not have come very far since the late 1980s. We can only hope the commentariat are wrong about the RBA. I think they are, but this still leaves the problem that Australian monetary policy is surrounded by considerable confusion, an all too predictable consequence of Australia's antiquated framework for monetary policy governance.

posted on 20/7/2004

The world's most redundant book. Dodging the rain (and snow!) in the Mountains over the weekend, I found myself in one of the local bookstores catering to the *Bobos in Paradise* demographic and came across a volume titled *The Bush Hater's Handbook*. I seriously doubt the target market really need a book to help them out on this score, but it confirms the Bush-hatred genre as a publishing phenomenon. Not to be outdone (and once again proving the derivative nature of the indigenous Left), there were plenty of freshly minted volumes in the Howard-hatred genre, too baleful to even mention by name. I think this says more about the misjudgements of publishers than it does about the preferences of the reading public, although presumably they know their business better than I do (far be it for me to cry 'market failure'!)

On a more positive note, the weather allowed me to finish Peter Watson's *A Terrible Beauty*. Reading Watson is a bit like reading *The Economist*: when you get to a subject you know something about, the discussion suddenly seems a little wide of the mark. Still, Watson's purpose is not to go into any single idea in a deep way, but to show how it relates to his overall narrative about the development of modern thought. Beginning the chapter on the 1960s with a discussion of Hayek's *Constitution of Liberty* (1960) and Friedman's *Capitalism and Freedom* (1962) is certainly a novel approach to a decade not otherwise noted as a highpoint of classical liberalism.

Also finished P J O'Rourke's *Peace Kills*. Some claim O'Rourke is less funny that he used to be, but I think this is only because his style has become much more familiar and lacks the novelty it once had. O'Rourke's style is very similar to Peter Ruehl's and they have one other curious thing in common: both their fathers were FBI agents. Many years ago, I asked Ruehl if he had met O'Rourke when they both covered the America's Cup in Perth. He said he hadn't, although that might have changed since. Incidentally, Ruehl's *American Downunder* (1992) should be compulsory reading for any American contemplating moving to Australia.

posted on 19/7/2004

Action Economics wins the CBS MarketWatch Forecasting Award for June. Well done Mike! You can sign-up for a free trial to Action Economics by clicking here and entering free trial code 'Institutional Economics.'

posted on 10/7/2004

The Economist unfavourably reviews *Michael Moore is a Big Fat Stupid White Man*:

This book unwittingly apes the filmmaker's over-the-top style. Its heavy-handed and self-congratulatory manner utterly defeats its purpose.

As it happens, some of the most devastating criticism of Moore comes from the realist left (and not just The Hitch). Here is just one of many examples that could be given, in which Moore is seen as symptomatic of a deep malaise on the left:

None of what I've discussed here would matter if Moore's techniques didn't symbolize bigger weaknesses in the American left today. Moore is not just a quirky guy with enough talent and dough to reach a wide audience. His political criticism signals problems faced by the left more generally: marginalization, a tendency to seek the purity of confrontation rather than to work for long-term political solutions, a cynicism about the possibilities of politics today, and questionable political judgments. Moore exhibits all these weaknesses. Unfortunately, an effective left cannot draw energy or inspiration from a deeply cynical view of politics that blurs entertainment and argument. Moore takes short-cuts when it comes to politics. He entertains, but he doesn't always do much more. That speaks to the state of the left; we are angry and sometimes vocal, but we have too little to offer those looking for or needing social change. Meanwhile, the entertainment industry chugs on, denigrating serious political argument and avoiding deliberation. That is the depressing world Michael Moore has broken into.

posted on 9/7/2004

The House Price Bust that Didn't Happen. CommSec joins the ranks of housing 'bubble' skeptics:

CommSec head of research Ron Bewley said yesterday the firm's research suggested "average property prices in most cities will continue to grow" - albeit at a slower pace than in recent years.

Growth in the Sydney market would be about 10 per cent a year. Growth in other capital cities, except the strong Brisbane market, was likely to fall below 10 per cent.

The firm said any substantial leap in property prices was unlikely for another five to eight years.

CommSec relies on the ABS figures, which are based on settlement dates of property sales. APM's quarterly figures are based on exchange of contracts, which typically show trends two to three months ahead of settlement figures.

CommSec analyst Nikola Dvornak said he disagreed that housing prices across the country were set to fall sharply, as predicted by APM.

"These reports of falling prices were based on volatile data which is not adjusted for compositional changes," he said.

"The reports of falling prices are also based on quarter-on-quarter changes in house prices. Because very strong quarter-on-quarter growth was recorded in December 2003, the falls in March 2004 may be deceptive and are not necessarily indicative of a turning point."

Instead, CommSec forecasts house prices would reach a plateau.

"Does this constitute a housing price bubble? No it doesn't," Mr Dvornak said.

What makes this research even more credible (apart from the fact that it comes from Ron Bewley) is that CommSec's own business interests are within an asset class that competes with residential property for the attention of retail investors. Unlike the property industry, CommSec does not have much of an interest in spruiking the property market. CommSec's previous research has focused more on the risks of residential property from an asset allocation perspective.

posted on 7/7/2004

Nothing succeeds like success. RBA Governor Ian Macfarlane's reputation is such that Alan Kohler even credits him with things that took place before he became Governor:

Macfarlane began restoring the RBA's reputation when he held his nerve, while those about him lost theirs, during what turned out to be non-crises in 1994 (the inflationary boom that didn't happen), 1997 (the Asian crisis that didn't spread) and 2000 (the tech bust that didn't matter).

Macfarlane became Governor in September 1996, more than two years after the commencement of the 1994 tightening cycle. In any event, the 1994 tightening cycle saw 275 basis points of tightening in four months, including two 100 bps moves, the most aggressive tightening in the RBA's history of interest rate targeting. As for the 'inflationary boom that did not happen,' inflation rose to over 5% y/y by the September quarter 1995.

posted on 6/7/2004

The Australian Labor Party caucus remains split on the Australia-US FTA, with Steve Lewis noting that opposition leader Mark Latham will be:

unable to avoid a looming brawl within the Labor caucus over the proposed free trade agreement with the US. At present, the Opposition is genuinely split between those (such as Kim Beazley) who support the FTA and those, mainly on the Left, who appear implacably opposed...

Much will depend on the final report from the Senate committee inquiring into the FTA. Chaired by Labor's veteran senator Peter Cook, the committee will hand down its final report on August 12.

If Cook's report finds significant faults with the FTA, it may clinch a "no" vote, or a decision to defer a final decision.

While Howard is convinced the FTA will be hugely beneficial for Australia's economic future, Labor's hardheads appear sanguine at the prospect of opposing the deal in the election lead-up.

They claim the issue is not resonating with voters in the same way health, education and childcare are.

"It's not exciting any great passion in the community," says one Labor strategist.

That may be the case, but it would still be a brave call for Labor to turn its back on an economic agreement that forges closer ties with the only global superpower.

In fact, Andrew Norton has found that the Australia-US FTA commands a surprising amount of popular support relative to more general propositions about free trade. I suspect this is because a negotiated agreement implies some reciprocity, which is important in terms of public perceptions of trade liberalisation. Andrew's article is one of several that could be cited to counter Ross Gittins' claim that CIS and other free market organizations have gone to ground on the Australia-US FTA.

The claim that an Australia-US FTA would harm Australia's regional economic integration is faced with the embarrassment of a raft of bilateral FTA proposals coming out of Asia. This has Peter Gallagher worrying that Australia's approach is becoming too opportunistic. Sounds like an embarrassment of riches.

UPDATE: The latest Morgan poll continues to show support for the FTA.

posted on 5/7/2004

Distributed Knowledge. Cass Sunstein reviews James Surowiecki's *The Wisdom of Crowds: Why the Many Are Smarter Than the Few and How Collective Wisdom Shapes Business, Economies, Societies, and Nations*. The review canvasses some well known examples of distributed knowledge. Those familiar with the work of Sunstein will not be surprised that he wishes Surowiecki did more to 'celebrate the cognitive virtues of democratic judgments.' A major problem with the ability of the political process to access distributed knowledge is that election outcomes are necessarily very sensitive to the method of voting. Applying different methods of aggregation to the same set of votes can give very different outcomes. A nice illustration of this is the fact that it is possible to win a majority in the Australian House of Representatives with a minority of the two-party preferred vote, as in the 1998 Federal election. This arbitrariness is one reason why rational choice theorists do not necessarily privilege democratic outcomes and why markets are better able to access distributed knowledge than electoral processes.

posted on 30/6/2004

Housing and Capital Gains Tax. In the wake of the Productivity Commission inquiry into housing affordability, the usual suspects are lining up to blame capital gains tax relief for house price inflation. Many of the commentators on this issue have long had it in for capital gains tax relief and negative gearing. Housing affordability is just a convenient stick with which to beat the issue. Ross Gittins, who accused the PC of intellectual cowardice and dishonesty for its failure to highlight the issue in its interim report, is now citing the PC as an authority on the subject. It is sad to see that Alan Kohler has also fallen in with this crowd, saying that:

cutting capital gains tax by half in September 1999 was an egregious mistake.

The real distortion here is not the concessional treatment of capital gains, but the high marginal income tax rates that force people to try and minimise their income through investments in loss-making assets. The concessional tax treatment of capital gains (after a minimum holding period) does make this deal more attractive, since investors ultimately rely on the capital gain to make up for the income losses while holding the asset. But the fundamental distortion here is a tax system that forces people to minmise their income, not one that encourages them to seek out capital gains. As the RBA has noted in its research on the subject, investment property is predominantly held by people with very high incomes, precisely those people who need relief from punishing marginal rates of income tax.

New Zealand has no comprehensive capital gains tax and has experienced a dramatic house price inflation over the same period in the absence of a change to its capital gains tax regime. The US is also experiencing a house price inflation, where mortgage interest payments are deductible for owner-occupiers and capital gains are subject to generous roll-over relief. If Australia is breaking records in house price inflation compared to other countries, this has more to do with income tax than capital gains tax.

Those who want to eliminate the concessional treatment of capital gains have an agenda that has little to do with promoting housing affordability. Removing the concessional treatment of capital gains is no substitute for the more fundamental task of lowering punishing marginal rates of income tax.

posted on 29/6/2004

My review of Stephen Bell's *Australia's Money Mandarins: The Reserve Bank and the Politics of Money* is up in the Reviews section.

posted on 28/6/2004

You will be hard pressed to find reference to it in today's press, but 14 federal Labor MPs crossed the floor of the House to vote with the government on the Australia-US FTA, while another 40 abstained. I cannot recall a previous occasion when federal Labor MPs crossed the floor in such large numbers on a non-conscience issue. My understanding of ALP caucus rules is that crossing the floor is grounds for expulsion from the party, although this would appear to be an exceptional case and perhaps indicative that the ALP will ultimately vote in favour of the FTA, despite its current prevarication. At the same time, Labor state premiers have been distancing themselves from opposition leader Mark Latham's foreign and trade policies.

The internal dissent within the ALP is indicative of the fact that Mark Latham has presided over the wholesale moral and intellectual collapse of the ALP's formerly respectable positions on foreign, defence and trade policy. The significance of this has been missed by most of the commentariat. Paul Kelly is a notable exception in saying:

If Labor sinks the FTA, it will be seen as an alliance issue precisely because Latham has already chosen to make the alliance an issue. The combination of withdrawal from Iraq, a strategic retreat of sorts from the US and becoming the first nation to negotiate, then repudiate, an FTA with the US would leave the Australian people thinking that Labor had lost its grip on the national interest.

Kelly has also noted Latham's tendency to go to ground when the heat is on, saying that it is 'a sign of weakness unworthy of his real self.' Unfortunately, this *is* the real Mark Latham and no amount of reading books to fat-free kids is going to hide it.

posted on 26/6/2004

The Productivity Commission inquiry into First Home Ownership is out, which was prompted by Australia's recent experience with house price inflation, a phenomenon seen across the industrialised world. Although Australia's experience with house price inflation has perhaps been more pronounced than elsewhere, the global price shock to this asset class would seem to argue against country-specific explanations. As we have documented in previous posts, there have been so many dire predictions of a house price collapse in Australia from such a wide range of sources that we can hardly help but take a contrarian view.

Rental yields and vacancy rates are holding up surprisingly well for a market supposedly on the brink of collapse (see the recent industry presentations to ABE on this subject). The March quarter national accounts saw a large decline in ownership transfer costs, a good proxy for real estate activity, enough to subtract 0.2 ppts from growth over the quarter, with dwelling investment subtracting another 0.2 ppts. There is no doubt that we are seeing another cyclical downturn in activity for established and new dwellings, but that is not the same thing as a collapse in prices. There is nothing unusual about large cyclical swings in housing activity.

Tyler Cowen gives some important reasons why we should be suspicious of claims of a bubble in housing markets. I think the readiness to view housing as a bubble is encouraged by two forms of prejudice: the widely held view that housing is an 'unproductive' asset, when housing does in fact service one of the most basic human needs; and the widely held suspicion of wealth that is not acquired through physical labour, hence the suspicion of capital gains and the preoccupation with taxing those gains.

posted on 24/6/2004

Further to my previous post on elections and rational choice, we might consider the implications of non-rationality in the political marketplace. The rational choice model explains very well the fact that the ALP has essentially adopted identical policies to the Coalition on asylum-seekers - they are simply endogenising the preferences of the median voter. This is a major reason why it is impossible to take anti-government posturing based on this issue seriously. Indeed, I suspect the ALP is ultimately more averse to free trade in labour than the Coalition, which is the more fundamental issue. Opposition leader Mark Latham's active embrace of a broad-range of motherhood issues is consistent with a median voter strategy, designed to divert attention from government attempts to highlight points of substantive difference.

A notable exception is the ALP's attempt at non-bipartisanship on defence and foreign policy. It is a safe generalisation that the electorate favours a broadly bipartisan stance on these issues, whereas the ALP has explicitly sought to distinguish itself in a substantive way. Presumably, the ALP think that these positions are an electoral positive, but this is possibly a major misreading of the electorate. Paul Sheehan is one of the few members of the commentariat to pick up on this when he says:

whether Australians believe Mark Latham is the person to confront medievalism, or has already flinched in the face of it, may determine the coming federal election.

So does this imply a break-down of the median voter/rational choice model or a failure of rationality within the model? I am inclined to the latter interpretation. The ALP has allowed its own preferences and sophistry to get the better of it, moving it away from the preferences of the median voter (Peter Garrett's attempt to endogenise these preferences rings hollow). Just as the middle-class left destroyed its previous chance at electing a Labor government with its posturing on asylum-seekers, it may well have achieved the same outcome on Iraq and related issues. Obviously, this is not a judgement on the substantive issues, but points to the possibility of a massive failure of political strategy on the part of the ALP.

posted on 21/6/2004

Elections and Rational Choice. With a federal election looming, it is worth pondering whether election outcomes are random walks. We would expect the major political parties to optimise their policies as best they can around the preferences of the median voter ahead of any election (witness Australia's two major parties appropriating each other's policies in recent months). We should not, therefore, expect to observe any systematic variation in election outcomes, since this would imply a failure of the candidates to endogenise all available information. Of course, there are many informational and market inefficiencies that might be relevant here. But to the extent that the political marketplace is efficient, election outcomes should be random events.

Much election commentary has the same character as market commentary, being dominated by ex post rationalisation. After the election, the commentariat quickly establish a conventional wisdom about why an election was won or lost, yet these confident interpretations are noticeably absent ahead of the poll. Given some spectacular failures on the part of the federal parliamentary press gallery in calling Australian elections, such caution is justified. Rather than being a failure of punditry, this may simply reflect an inability to forecast the unforecastable.

Models that seek to relate the incumbent two-party preferred vote share to macroeconomic and other variables are not very robust, much like fundamental models of asset price determination, and give counter-intuitive results. Sportsbetting and the Iowa Electronic Markets typically do a better job of calling elections than opinion polls, although these have the advantage of including opinion polls in their information set. A more important factor is that participants in these markets have a much greater incentive to acquire political information than the average voter. For most people, the expected pay-off to voting is low. The probability of an individual's vote being decisive in a given contest is extraordinarily small. With even a negligible cost to voting, the individual pay-off from a given outcome would need to be extraordinarily high to justify a trip to the polls, which explains the low voter turn-outs in those countries where voting is not compulsory. The returns to acquiring political information for most people are low (rational ignorance).

You can place your bets on the Australian and US general elections here.

posted on 20/6/2004

The AEI-Brookings Joint Centre on regulatory attacks on VoIP telephony:

Regulators from New York to California are trying to bring VoIP under their regulatory tents. But extending anachronistic telephone taxes and regulations to innovative Internet services will harm consumers by raising prices, blocking competition and creating incentives for businesses to avoid those non-market costs.

Historically, regulators' jobs were to protect consumers from potential abuses by monopoly telephone companies. More recently, regulators have also been charged with promoting competition in the industry.

So why do regulators want to hobble competition from VoIP?

Unfortunately, telephone regulation today isn't really about protecting consumers or promoting competition. It's a process of taxing consumers to provide off-budget cash for funding politicians' and regulators' preferred constituencies. Most of the $14 billion raised annually comes from excessive charges to connect long-distance calls and is used to keep telephone prices low in rural areas. VoIP, by avoiding the old switched telephone network, threatens to undermine this entire subsidy system.

If you don't like cross-subsidising the rural rich, or just want to eat into Telstra's annual dividend to Commonwealth government, Skype provides a free P2P telephony service that is simply amazing.

posted on 19/6/2004

If you hear the phrase 'nation-building' in an election year, you know it is time to hold on to your wallets, as Alan Wood explains. I have never entirely understood the hold that this phrase has on Australia's public imagination. It recalls Menzies era post-war reconstructionism and Rex Connor's Stalinesque public works white elephants of the Whitlam years. The Prime Minister routinely invokes this phrase, knowing that it has the resonance required to cloak a boondoggle. Interestingly enough, in American public discourse, 'nation-building' is a phrase generally used in discussing developing countries and failed states.

posted on 15/6/2004

Niall Ferguson is one of many commentators arguing that the US somehow depends on the big dollar's status as a reserve currency to subsidise its consumption and investment and that the euro threatens this reserve currency status:

If the Europeans seize their chance, Americans could face the end of half a century of dollar domination. Does it matter? You bet it does. For if Asian institutions start rebalancing their portfolios by switching from dollars to euros, it will become harder than it has been for many years for the US to fund its private and public sector consumption at what are, in terms of the returns to foreign lenders, low or negative real interest rates.

The Japanese Ministry of Finance has long promoted the 'internationalisation of the yen,' by which it means encouraging the use of the yen as a reserve currency and as a unit of account. Unfortunately, it is also in the business of trying to devalue the yen through foreign exchange intervention and debt monetization, which is not exactly conducive to promoting the yen's use as a store of value. The idea that the 'reserve' status of a currency underpins its value has little applicability in a world of floating exchange rates.

Equally dubious is Ferguson's claim that a shift to greater use of the euro will put upward pressure on US interests, adversely effecting long-term growth outcomes. The real equilibrium interest rate is a function of long-run trend growth, which in turn is a function of productivity growth. High real interest rates are in fact a symptom of strong growth, not a threat to it. To illustrate, Australia has some of the highest interest rates in the world, yet it has also seen the strongest growth performance in the industrialised world in the 1990s-early 2000s, partly due to strong productivity growth. This is why Australia's current account deficit and negative net international investment position are not a concern.

What is remarkable about the US is that while neo-classical growth theory would predict that other countries should converge on US GDP per capita, the US keeps pushing out the growth and productivity frontier, leaving other industrialised economies struggling to keep up. It is this strong growth and productivity performance that will enable the US to continue to enjoy a high standard of living. Interest rates and exchanges rates are bit players in this process. The idea that US growth prospects and living standards depend on where foreign central banks park the proceeds of their foreign exchange market interventions or on the composition of their foreign exchange reserves is ludicrous and does not say much for Ferguson's grasp of economics.

posted on 9/6/2004

Yasheng Huang puts China's growth in historical perspective:

the idea that China has "risen" is quite misleading; in fact, China has resurrected itself after being the world's largest economy throughout much of history. According to Angus Maddison, an economic historian, China accounted for one third of the world's gross domestic product in 1820 and in the 13th century was ahead of Europe in per capita income terms. Even in 1960, China was just a few years behind Japan in its technology for the machine tools industry. The point here is that China's economic achievements have not matched its vast economic potential. This is not to detract from its remarkable progress of the last 20 years, but to say that China is simply catching up with, rather than increasing, its economic potential. In 2002, in purchasing power parity terms, China's GDP accounted for 12 per cent of global GDP. In terms of exchange rates, however, this falls to 4 per cent - less than the 5 per cent claimed by China in 1952. For economic historians, one puzzle is not why China has grown so fast but why it is so poor in the first place. In Asia, China is conspicuously absent from the postwar economies that caught up with the west's living standards. This says something about the current outcry in the west over "job losses" to China. In many ways, China "lost" many of these jobs to east Asian neighbours because its leaders made terrible policy choices, embracing central planning and economic autarky before market reforms in 1978.

Huang also questions the all-pervasive "Made in China" label. He suggests that

"Processed in China" is a more accurate characterisation, as well as having different connotations.

posted on 8/6/2004

Stephen Bell's *Australia's Money Mandarins: The Reserve Bank and the Politics of Money* can be found in extract in today's *AFR*, ahead of its launch by Bernie Fraser, Australia's most disastrous central bank governor, at the UQ bookstore on Tuesday. Bell argues in favour of the distinctiveness of the RBA's framework for monetary policy. The following is an extract from my own review of Bell's book, which will be forthcoming in the next issue of *Policy*:

Bell is correct in identifying the RBA's exceptionalism as a key issue. Although the RBA is an inflation targeter, its target is only loosely defined, the Bank retains a conflicted statutory mandate and it lacks the rigorous accountability and transparency measures that accompanied statutory reform of central banking institutions in other countries, most notably the Bank of England and RBNZ. Bell sees the RBA's failure to embrace key elements of central bank reform and its apparent success in the discretionary conduct of policy as a challenge to the theoretical rational choice literature that underpins the arguments of reformists. Bell joins the consensus view in seeing Australia as being fortunate in avoiding New Zealand's experiment with central bank reform, now partly abandoned in favour of the Australian approach, although still leaving the RBNZ with a much more rigorous governance framework than the RBA.

The problem with this view is that there is no evidence that Australia's fortunate macroeconomic experience in the 1990s is due to Australia's distinctive approach to monetary policy governance, as opposed to what the RBA does share in common with other central banks, which is an increased commitment to price stability relative to previous decades. Australia has shared in what has become known as 'The Great Moderation,' the decline in the volatility of inflation and output across the industrialised world in the 1990s. There is considerable debate in the economics profession about the role that changes in monetary policy practice might have played in this, but there is no consensus on this issue.

The RBNZ is a natural point of comparison for the RBA and Bell subscribes to the myth that the RBNZ's more rigorous approach to inflation targeting has been a negative for its economy. Disentangling the specific contribution of institutional arrangements to macroeconomic outcomes is an extremely difficult task, one that even economists find daunting, but a superficial review of the data does not support this view. Even including New Zealand's 1998 recession, average GDP growth and the output gap in New Zealand have been little different from Australia, while the unemployment rate has been significantly lower. The literature on central bank policy preferences suggests that the RBA has, if anything, been more zealous in its response to inflation than the RBNZ.

The governance framework for monetary policy in Australia is certainly distinctive, but this distinctiveness is little more than an historical by-product. There is no specific theoretical or empirical evidence in its favour and many arguments that can be raised against it, both from a procedural and economic perspective.

posted on 4/6/2004

The Iowa Electronic Markets 2004 US Presidential election winner-takes-all contract is now open. There is at least one reason to question the informational efficiency of the IEM markets. The IEM say that 'the market is open to all traders world-wide,' but this ignores the additional transaction costs imposed on non-US participants in opening an account. Apart from US dollar cheques drawn against US banks, the IEM does not support low cost payment methods. These transactions costs would limit participation in this market by those outside the US. Yet non-US participants might bring additional information to this market. For example, non-US participants might view US politics more objectively than those caught up in domestic partisanship. To the extent that the election outcome might have different implications for those inside compared to those outside the US, foreign hedgers might be more inclined to take one side of the market than the other. The IEM could increase the depth and liquidity of its markets by making them more accessible to foreigners.

posted on 4/6/2004

P J O'Rourke's formula for restoring love and respect for the US: isolationism. I am assuming O'Rourke's counter-factual is being posed rhetorically. If so, it is a nice satire on the old world isolationism that still has a strong grip on classical liberalism in the US, not least the Cato Institute, with which O'Rourke is closely affiliated. Classical liberals outside the US tend to have much stronger internationalist leanings. As O'Rourke suggests, I think this is because a world with an isolationist US is a much scarier proposition for those of us living outside the US. The idea of a liberal society hiding behind its own borders has always struck me as being considerably more statist than an activist internationalism that sees free societies as having an obligation to help liberate oppressed peoples when the opportunity presents itself.

In any event, the money quote from PJ has to be the following:

At a theoretical level there may be no reason why Isolationism, Protectionism and Nativism should be conjoined. But we can hardly have Larry and Curly without Moe.

Just as can't we have Bob Brown and Natasha Stott-Despoja without Pauline Hanson, our very own Three Stooges of isolationism.

UPDATE: PJ fans can buy an autographed copy of his latest book, *Peace Kills* from LFB for only USD 15.95. Orders before July 1 will also get a free copy of O'Rourke's *Eight Little Civic Lessons From the Early Days of the George W. Bush Administration*.

posted on 1/6/2004

David Friedman, author of the anarcho-capitalist classic, *The Machinery of Freedom*, will be at the NZ Association of Economists Conference in Wellington at the end of the month, as will Patrick Minford. Looks like an interesting conference. The Economic Society of Australia's Conference will be in Sydney this year and has a somewhat less interesting line-up. My submission is up in the Working Papers section of this site (a more complete version will be presented at the conference itself).

posted on 1/6/2004