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Articles for the Month:

Happiness Research.
The Australian's economics correspondent points to NBER research on the relationship between sex and happiness. No prizes for guessing the conclusion. I haven't had a chance to check the authors' methodology, but superficially it would seem that this result is just a function or subset of the well known happiness benefits of being successfully partnered. For a local angle on the story, the journalist cites happiness researcher at the Australian National University, Paul Frijters: *He notes that many would regard it as the job of the state to create the conditions that make people happy.* And what a bang up job the state has been doing as a purveyor of happiness these last few hundred years or so.

posted on 5/29/2004

Tim Blair
illustrates the media phenomenon of attaching political labels to right-of-centre think-tanks in Australia, while left-of-centre institutes attract much more neutral labelling. A bigger problem is that many in the media have little awareness of the many streams of liberal and conservative thought, so that the attempted use of scare labels ends up being a gross mischaracterisation of their actual ideas. Calling the Centre for Independent Studies 'neo-conservative' is perhaps the worst example of this, even allowing for the general misuse of the neo-conservative appellation. The more neutral labelling attaching to the Australia Institute perhaps reflects the fact that its ideas are very hard to characterise. Like many on the left, the Institute largely defines itself in oppositional terms, because its ideas are too incoherent (or too scary) to frame as a positive program. 'Communitarian' would be a fitting, although somewhat euphemistic, label for the Australia Institute. It is certainly too far to the left to qualify as 'social-democratic.' Given the left's habit of labelling classical liberals as neo-liberals, perhaps we should return the favour by coining the term 'neo-socialist?'

posted on 5/25/2004

Australian industry policy
picks another winner.

posted on 5/22/2004

Shadow Treasurer Simon Crean
is floating the idea of an intergenerational fund. Although this is a terrible idea, for reasons argued below, it is interesting in the context of the ALP's commitments to reduce the Federal tax and expenditure shares of GDP, increase spending on the fiscal black holes of health and education, while presumably also keeping the budget in surplus. These policies could be reconciled, but only through some major expenditure cuts in other areas of the budget. The ALP claims to have identified around $8 billion in savings, which is not too far off the sort of measures John Hewson proposed in Fightback ahead of the 1993 Federal election. The totality of what the ALP is proposing would seem to imply an unprecedented degree of fiscal discipline that should send shudders up the spine of any spend-happy social democrat. On a less optimistic note, the ALP is backing away from its commitment to remove the Secretary of the Treasury from the RBA Board, although it will demand more detailed explanations of unchanged policy outcomes. Australia is exceptional is allowing a representative of the government voting rights in setting monetary policy. Even the Bank of Japan has only non-voting government representation on its policy board. The framework for monetary policy governance in Australia falls well short of world's best practice. Mark Latham was active on this issue as a backbench member of the House Economics committee, but the ALP now seem to have lost interest.

posted on 5/20/2004

Ross Gittins
argues that we have a preference for taxation by stealth, because we are too irrational to appreciate the joys of direct taxation: *I think it's fair to assume, however, that most people would find passing up a tax cut easier to accept than an explicit tax increase. That's the point about bracket creep: it's the least painful way for the politicians to deliver us better schools and hospitals.* Politicians delivering *better* schools and hospitals? Try not to laugh.

posted on 5/19/2004

Australian Treasury Secretary Ken Henry
has turned the annual post-Budget address to the Australian Business Economists into an event of considerable interest. This year's contribution says a great deal about the political economy of fiscal policy and structural reform in Australia. Henry confronts Australia's fiscal policy options and makes a clear case for the Treasury view on these options. Reassuringly, he rejects the NZ model of inter-generational tax smoothing, in which the government becomes an inter-generational financial intermediary, which would necessarily entail a very substantial role for government in financial intermediation and financial markets. This is the option favoured by Ross Gittins and, together with its blank cheque approach to underwriting the ever increasing demands of the welfare state, implies a massive increase in state power at the expense of civil society. Henry also rejects the preferred option of commentators such as Alan Kohler (and myself) of rolling back the welfare state and essentially privatising the national saving task implied by demographic change. Henry's preferred approach is to increase labour force participation and labour productivity to ensure that economic growth closes the prospective intergenerational fiscal deficit. His suggestion is rather than trying to rollback government spending per capita, we focus on growing GDP per capita as a way of containing the increase in government spending as a share of GDP.

This approach has merit in its own right, not just as a solution to the prospective intergenerational fiscal shortfall, although the task is made much more difficult by the implicit blank cheque that is being written for the welfare state. Perhaps Henry is acknowledging the political reality that rolling back the welfare state will be so electorally difficult as to make it altogether unlikely. In that case, however, it is surprising that he thinks that reforms to improve labour productivity and labour force participation will be any easier. Henry tries to spin the Budget as a positive contribution to these goals, but the Budget's contribution is marginal at best and broader progress on structural reform in the Australian economy has come to a grinding halt. It is a damning indictment of Australia's policy establishment that the great structural reform agenda of the 1980s and 1990s has now been reduced to measures such as taxpayer-funded baby-sitting.

posted on 5/18/2004

Federal Opposition leader Mark Latham
undertakes to reduce the Commonwealth outlay and revenue shares of GDP in his Budget reply speech, saying Labor believes in 'limiting the size of government.' Latham has yet to quantify these targets or how they would be achieved, but it at least shows that the ALP is giving serious consideration to the adoption of a fiscal policy rule. Unfortunately, commitments of this type do not have a very good track record. The previous Federal Labor government made a similar commitment as part of its 1984 'trilogy' under which the tax, spending and budget deficit shares of GDP would be reduced in 1985-86 and over the life of that parliament. The second and third of these commitments were met, but not the first, although the cyclical component of fiscal policy arguably made the main contribution to these outcomes. Similarly, the current government undertook to keep the Commonwealth revenue share of GDP below 1996-97 levels, a commitment that has only been honoured if you take current government accounting practices seriously. It is widely agreed that this is the highest taxing government in history, with argument mainly focussed on the exact year of the peak. The budget papers highlight the secular increase in the revenue and outlay shares of GDP over all governments. We can only look forward to Latham spelling out the detail of how his commitment will be made good. We also look forward to John Quiggin repudiating Labor as the party of limited government and endorsing the Coalition for its success in expanding the size of the state.

posted on 5/14/2004

Virtual Spontaneous Order.
An article on Castronova's 'Virtual Worlds: A First-Hand Account of Market and Society on the Cyberian Frontier.' The author's attempt to overlay the ideas of Smith and Marx is pretty ham-fisted, but the background to Castronova's paper is interesting.

posted on 5/13/2004

Big Spending Conservatives.

The 2004-05 Federal Budget takes fiscal Hobbesianism to new levels, with generalised tax relief being neglected in favour of massive increases in assistance for families. Alan Kohler, Australia's most perceptive economic commentator, has consistently highlighted the massive expansion in the welfare state implied by the current government's successive budgets and argues that this budget is no exception: *It is undoubtedly the greatest across-the-board injection of cash into the government sector for years, if not ever. And it will be very difficult, if not impossible, for that money to be taken away again.* Ross Gittins implies that the government should be spending more on the fiscal black holes of health and education, as well as running large budget surpluses to meet future unfunded contingent liabilities in relation to an aging population (he seems to favour the NZ model for an inter-generational fund). Gittins' criticisms of the Budget imply a preference for a massive increase in taxes and an enormous increase in state power at the expense of civil society. Gittins implied policy preferences are a taxpayer's worst nightmare. Most of the criticism of the budget is directed at the failure to use budget surpluses to meet the massive prospective fiscal shortfall highlighted by the government's own Intergenerational Report. But as the current budget highlights, governments are constitutionally incapable of sitting on large surpluses. Even if governments could bind themselves into running-up large surpluses, the implications of governments administering large asset portfolios are too frightening to contemplate. It is bad enough that governments dominate markets for services like health and education, without them taking over financial markets as well. There is no reason for governments to act as inter-generational financial intermediaries. Individuals are more than capable of performing this task, given the right incentives. This means rolling back the welfare state and the associated taxes to restore incentives for private precautionary saving. Restoring consumer sovereignty with respect to health and education would also be helpful in this regard. The alternative is that the politics of fiscal policy will turn increasingly nasty, as fiscal policy degenerates into a war of all against all.

posted on 5/12/2004

Haruhiko Kuroda, adviser to the Japanese Prime Minister,

is defending Japan's monetary and exchange rate policies in this op-ed: *Japanese monetary policy, led by an active central bank governor, has contributed to the sea-change in the zero interest rate climate, but it has done so in conjunction with the government's robust exchange rate management.* On most measures, such as money base growth, the current BoJ Governor has actually been somewhat less activist that his predecessor, although Govenor Fukui has skillfully managed to create the opposite impression. The suggestion that Japan's current cyclical upswing is due to easier monetary policy is not credible. Japan's economy is much more cyclical than most people realise. Far from being in a recession over the last decade, Japan has seen a very pronounced cycle around a lower trend growth rate. The decline in trend growth is mostly attributable to real factors. These pronounced cyclical swings are very hard to explain with reference to monetary policy indicators. As for the exchange rate, Kuroda is simply trying to put a friendly face on beggar-thy-neighbour exchange rate intervention. Given Japan's very marginal contribution to world growth over the 1990s, the argument that what is good for Japan is good for the rest of the world is at best an exaggeration. The best that could be said for Japan's massive exchange rate intervention is that it contributed positively to liquidity in foreign asset markets, but even that contribution is becoming increasingly irrelevant, as the global tightening cycle intensifies. Kuroda once again tries to link exchange rate intervention to monetary policy, in an attempt to make the former look more respectable.

posted on 5/11/2004

Samuel Brittan's

advice to EU accession countries contemplating euro membership: just say no. Brittan argues instead for greater diversity in currencies and increased efforts at promoting currency competition. Brittan does not make the argument explicitly, but he clearly recognises that the microeconomic benefits of a common currency are more than offset by the increased probability of macroeconomic disaster under an inflexible monetary regime covering a broad swathe of Europe. The euro zone's current economic underperformance is attributable at least in part to its inflexible monetary regime.

posted on 5/9/2004

Harvard Business School

has long been a bastion of mercantilist thought. HBS assistant professor Jonathan West provides a classic example of the genre in today's *Australian*: *AUSTRALIA'S economic success during the past decade has been achieved through the consumption of technology, not its production. Australia has not innovated to achieve economic success. Rather, it has been a world-class consumer and adopter of technology overwhelmingly invented, tested and manufactured overseas. In this respect, Australia's experience stands in sharp contrast to that of other developed nations that enjoyed sustained economic success, which have done so by creating new technologies.* Nowhere does West mention the fact that Australia's status as a net consumer rather than producer of ICT has just spared it from a severe global economic downturn or that the decline in prices for ICT goods is underpinning a reversal in what had previously been a secular decline in Australia's terms of trade. In other words, Australia's national income is increasing due to the decline in prices of ICT goods that Australia consumes heavily and is fortunate enough *not* to produce. Australia's stunning economic performance of the last decade owes much to the market-oriented pursuit of its comparative advantage and spurning this sort of cargo-cultism, so popular in management education circles.

posted on 5/7/2004

Australia's free trade debates of the late 18th and early 19th century

still resonate today, although it can be depressing to see how little things have changed over the last century. Liberty Fund has now reproduced Bruce Smith's 1887 *Liberty and Liberalism* (I suspect David Hart might have encouraged their interest in this material). It contains this amusing passage, which also reminds us how little some things change: *I have mentioned the "Liberal" Press of Victoria, or rather that section of the Press which professes "Liberal" principles, because of the prominent part which it assumes, and is, in fact, allowed to take in the settlement of the public affairs of that colony; and, further, because it exercises, in matters political, an immense amount of influence over the masses, which it has, unfortunately, and whatever may have been its motives, more often than not, so directed, as to intensify rather than allay any class animosity, which has arisen from other causes.* On a more contemporary note, the CIE's analysis of the Australia-US FTA is available here. The discussion of the report in the comments section of John Quiggin is well worth a look.

posted on 5/6/2004

David Malpass

argues that the US budget deficit has little to do with the outlook for interest rates: *In a globalised capital market, interest rates depend on the borrower's creditworthiness. For sovereign loans, interest rates vary substantially with inflation and currency expectations and with credit risk, but generally not with the amount of the loan. This is why Japan's borrowing cost for the 10-year fixed rate bond is only 1.6 per cent, despite a budget deficit equal to 8 per cent of gross domestic product. The same applies to corporations, where borrowing costs depend on the currency being borrowed and the corporation's creditworthiness, but generally not the size of the debt issue. As a practical matter, a bigger debt issue may bring a lower interest rate because of liquidity considerations. Even for households, larger mortgages often bring lower, not higher, interest rates. Recent history offers the clearest proof of the disconnect between interest rates and the US budget deficit. The deficit has been growing for several years yet interest rates and bond yields went the other way and fell to new lows owing to deflation expectations. Critics of the George W. Bush tax cuts argued that the deficit effect would cause higher interest rates and slower growth, only to find lower interest rates and faster growth.* It is also pleasing to see that the 'consenting adults' view of current account deficits, widely accepted in Australia, has some adherents in the US: *On Wall Street, the analysts most worried about the US twin deficits have generally expected them to weaken the economy and hold back Fed rate rises. Instead, the economy has done well and rates will probably rise sooner rather than later. In many ways, the trade deficit actually supports this durable growth outlook. As the US economy outperforms most of its trading partners, it draws in more imports than they do. The economic question with a trade deficit is whether a country's investment climate is more profitable than its cost of capital? If so, the trade deficit is a form of constructive leverage. It's very hard to connect this to the level of interest rates. The capital inflow associated with the trade deficit adds to US investment, which creates more goods and restrains inflation. The added economic activity increases demand for capital and the real interest rate. In the end, if real rates rise it is due to higher growth and increased investment opportunities. As the US heads toward higher interest rates, it's important to keep in mind the primary causes: faster growth and a welcome exit from the deflationary pressures of recent years.* The only puzzling aspect of Malpass' op-ed is the disclaimer 'these views are his own.' Surely it is unusual for the chief economist of a US investment bank to have to dissociate his views from his employer? Are these views too rich for Bear Stearns?

posted on 5/4/2004

Ross Gittins

claims Australian financial markets are overreacting to recent developments in the US, illustrating their 'susceptability to fads and fashions,' a favourite Gittins hobbyhorse. As it happens, these themes were also the subject of a recent speech by RBA Governor Macfarlane, suggesting that they are also a preoccupation for Australian policymakers. The business and interest rate cycles of Australia and the US are highly correlated, more so than conventional transmission mechanisms would seem to warrant. Australia saw a dramatic easing in monetary policy in 2001, despite a resilient domestic economy, precisely because of this close relationship. Australian financial markets are not mere fashion victims in paying close attention to developments in the US. It is remarkable the extent to which the dollar-bloc periphery (Australia and NZ) in fact leads the global business and interest rate cycle. If Australian financial markets are overly impressed with developments in the US, it is because of this close relationship with the domestic cycle.

posted on 5/2/2004