Institutional ECONOMICS

Archive

Articles for the Month:

The largely cyclical deteriorations in the current account deficits of the US and Australia have seen the equally cyclical recurrence of current account deficit angst in both countries. Here is one of many examples, which makes the following observation: *With a collapse in interest rates fuelling consumer spending, it is conceivable that the US current account deficit will explode upwards. There is no magic number the current account deficit must reach to signal an impending crisis - but there has never been a nation that has been able to increase its reliance on foreign savings without eventually hitting a brick wall.* Australia seems to have avoided hitting this wall for about 200 years. I remember Max Corden saying that worrying about the 'unsustainability' of a current account deficit was a bit like worrying about the 'unsustainability' of the growth of a teenager. Much of the angst ultimately comes down to various types of capital xenophobia.

posted on 7/31/2003

Reaction to Ian Macfarlane's reappointment as RBA Governor has been revealing. Saul Eslake praises Macfarlane as potentially 'the most successful governor in the history of the RBA.' But as Saul indicates, this has a lot to do with the institutional changes made during his term. Processes are just as important as personalities. Saul would make a pretty good RBA Governor himself, if we could ever lever him out of Melbourne. Perhaps most surprising was the reaction of *AFR* economics editor, Alan Mitchell. Mitchell sees the current low inflation environment, coupled with an asset price boom in residential property as an argument for reviving discretionary fiscal policy and for the central bank to target asset prices. Coming from a sensible guy like Mitchell, this is a worrying indication of how much intellectual ground is being lost to those who argue that the authorities have a better idea than markets what an appropriate level and growth rate for asset prices might be. On fiscal policy, I think Mitchell misses the point about the debate in the UK, which has been more about instituting a fiscal policy *rule* that would kick-in when output was below potential. Alex Erskine has been advocating something similar for Australia for some time. This is more defensible than a discretionary fiscal policy regime, although not without problems of its own.

posted on 7/30/2003

Robert Shiller should be all in favour of the Pentagon's aborted Policy Analysis Market, shouldn't he? **UPDATE:** One of the very few defences of the proposed PAM can be found here.

posted on 7/30/2003

Ian Macfarlane

has been reappointed for another term as RBA Governor, although only for three years, rather than the maximum seven. This will still see Macfarlane as the second longest serving RBA Governor, after Nugget Coombs. Apparently, Macfarlane did not want to serve the maximum seven year term. While understandable from a personal point of view, this is an unfortunate precedent, in that a three year term risks putting the RBA Governor's appointment approximately in sync with the political cycle. Macfarlane and the Treasurer have agreed to a new Statement on the Conduct of Monetary Policy, setting out their joint understanding of the RBA's objectives. There is no substantial change compared to the previous exchange of letters. This is another missed opportunity to define a more rigorous and transparent framework for the conduct of monetary policy in Australia. However, Macfarlane's success under the current framework means that there is no real constituency for change. The statement concludes by saying: *The Government and Bank continue to recognise that outcomes, and not the arrangements underpinning them, will ultimately measure the quality of the conduct of monetary policy.* It is truly bizarre that having engaged in an exchange of letters that implicitly recognizes that processes are fundamental to outcomes, the Treasurer and the Governor should then try and turn this relationship on its head by explicitly arguing that outcomes are somehow independent of processes.

posted on 7/29/2003

Robert Chote

discusses the potential costs and benefits associated with committee-style approaches to monetary policy decision-making, with reference to the Bank of England. His analysis highlights why the BoE's framework is a model that deserves close attention: *The Bank of England has been very dissent-friendly by comparison, with occasional 5-4 votes and the governor and deputy governors taking different sides - and yet the markets have lived to tell the tale. Some observers wonder whether Mervyn King's ascent to the governorship might see him - formally or informally - exert more directive leadership like Alan Greenspan at the Fed. But Ms Lomax at least seems happy to dissent under the new regime and it seems unlikely on his own past performance that Mr King will lose sleep if others do too. Several factors may explain why the Bank has developed the culture it has. Like the Fed, its deliberations are transparent with votes published. But, unlike the Fed, the committee has been given an unambiguous quantified target and members are held individually accountable. Culture also reflects the types of people appointed. Bankers and representatives of interest groups have largely been eschewed in favour of economists, who are naturally disputatious and rarely wracked with self-doubt. In this environment, even Bank lifers doubtless feel liberated. Procedures matter too. Sir Edward George, the outgoing governor, typically spoke last at MPC meetings and only gave clear direction at the outset on five or six occasions - an example Mr King says he will follow.* The BoE's culture of transparency in relation to its decision-making contrasts with that of the RBA. Although the RBA has gone a long way to making its procedures more transparent in recent years, it still falls well short of world's best practice.

posted on 7/29/2003

The Cato Institute's Dan Griswold
makes the case for FTAs from a US perspective: *The multilateral system makes room for free-trade areas through Article 24 of the General Agreement on Tariffs and Trade. The World Trade Organisation's charter allows customs unions or free-trade agreements between members, recognising "the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of [those] countries". More than 250 such agreements have been negotiated; if the Chile and Singapore agreements become law, the US will be party to exactly five.*

posted on 7/28/2003

Alan Greenspan's
record is the subject of a feature in the *AFR Magazine* by Peter Hartcher. The article is mostly a recycling of some increasingly tired Greenspan anecdotes and factoids. But it also argues that Greenspan is responsible for America's most recent boom and bust. The article implies that Greenspan kept policy too easy for too long, in contrast to the view that he tightened policy too aggressively, too late. Of course, these views could be reconciled by arguing that monetary policy was systematically mistimed. There is a much bigger story here, one that most journalists miss because of their preoccupation with personalities at the expense of processes: the US operates an almost entirely discretionary monetary policy regime, unconstrained by a formal inflation target or other policy rule. But there is no suggestion amongst all the criticism of Greenspan that perhaps US monetary policy should be made subject to the rule of law. Instead, Hartcher effectively argues for an even more discretionary and activist Fed that would target asset prices: *But probably the most important reason for Greenspan's ability to drive into a $US6.5 trillion car crash and walk away unscathed is that when he erred, it was an error within the prevailing orthodoxy. The economic orthodoxy said that the only danger that a central bank should confront with restrictive monetary policy - higher interest rates - was inflation. And this refers to inflation in the commonly understood sense of inflation in consumer prices. The US was not suffering an inflationary outbreak, so, according to the prevailing wisdom, there was no need to act. There are early signs the orthodoxy is now being rethought.* The view that asset prices should be a target of policy is gaining ground, partly because of a misinterpretation of the work of the behavioural finance school, which confuses individual irrationality with informational inefficiency. But the view that any single authority or personality could determine an appropriate level or growth rate for asset prices effectively revives the wrong side of socialist-calculation debate from the 1930s. A rule-bound nominal anchor, in conjunction with other rules designed to promote market efficiency and integrity, would minimise the risk that monetary policy might destabilise asset prices. An activist monetary policy that sought to target asset prices would be a recipe for disaster.

posted on 7/25/2003

FRB Governor Bernanke

elaborates the significance of the 6 May FOMC statement: *That statement was the first to assess the risks to economic activity and inflation separately, recognizing explicitly that upside and downside risks to inflation could exist under varying conditions of the real economy. Previous FOMC statements had characterized the balance of risks one-dimensionally, as being either in the direction of economic weakness or in the direction of excessive inflation. The May 6 statement was more than a procedural innovation; it also broke new ground as the first occasion in which the FOMC expressed the concern that inflation might actually fall too low.* Bernanke also hints that the Fed has been working hard on alternative approaches to monetary policy should the zero bound on nominal interest rates become a constraint on policy: *Should the funds rate approach zero, the question will arise again about so-called nontraditional monetary policy measures. I first discussed some of these measures in a speech last November. Thanks in part to a great deal of fine work by the staff, my understanding of these measures and my confidence in their success have been greatly enhanced since I gave that speech. Without going into great detail, I see the first stages of a "nontraditional" campaign as focused on lowering longer-term interest rates. The two principal components of that campaign would be a commitment by the FOMC to keep short-term yields at a very low level for an extended period…together with a set of concrete measures to give weight to that commitment. Such measures might include, among others, increased purchases of longer-term government bonds by the Fed, an announced program of oversupplying bank reserves, term lending through the discount window at very low rates, and the issuance of options to borrow from the Fed at low rates.* Given Japan's experience, it is difficult to share Bernanke's confidence in such measures, in the unlikely event that they are needed. Meanwhile, Australian and NZ official interest rates continue to converge. It is becoming conventional wisdom that the only thing standing in the way of an official interest rate cut in Australia is the RBA's concern about the property boom. But this argument implies that the RBA is now in the business of targeting asset prices, as well as inflation. Previously, the RBA has been appropriately sceptical about the wisdom of targeting asset prices.

posted on 7/24/2003

More deflation skepticism

from Avinash Persaud: *The Fed's switch to an inflationary policy has been carried out under the perceived threat of deflation. There are, however, few signs of deflation in the US or in the world economy as a whole. In the US, inflation is above zero and rising. Globally, equity markets are outperforming bond markets and commodity prices are strengthening. Non-Japan Asia, the world's second largest economic bloc, is achieving 6 to 8 per cent growth. The main sources of deflationary pressure are Japan and allegedly China. However, the latest data show that capital expenditure is recovering in Japan and that inflation has risen above zero in China. The bond vigilantes may conclude that the official deflation-mongering, including the hints of a possible recourse to unconventional monetary policies, was merely a ruse to hide this switch to an inflation policy, or at least intended to soften the blow to the bond market. Certainly the idea that the Fed may consider buying long-term bonds, signalling the central bank's concern about deflation, was always a non-starter in practice. If there were deflation, long-term interest rates would already be* *low and falling; there would be no need to lower them further. If deflation beckoned but the markets were still worried about inflation and so yields were high, printing money to buy bonds would only raise inflation expectations further, sending bond yields yet higher. The Fed's inflationary turn will undermine fixed-interest assets, such as government bonds and the dollar. But it will support real assets such as US industrial equities, globally leveraged assets such as Asian equities and commodities and commodity-linked currencies. This is the Greenspan legacy asset allocation. But investors will have little time to get used to it.*

posted on 7/23/2003

The Battle of the Models

Mark Davis continues his look at the arguments over an Australia-US FTA, focussing on the results from the econometric models employed by the main protagonists and some of the key differences in their assumptions: *The government-funded Rural Industries Research and Development Corporation last year asked ACIL Consulting to review the implications of an FTA for the agriculture sector. ACIL used Tasman-Global, a modified version of the GTAP model employed by CIE, and followed the same procedure as CIE, comparing a no-policy change scenario with a scenario in which Australia and the US removed all tariffs. The results are significantly different. ACIL estimates that Australian GDP will fall by 0.02 per cent by 2010 compared with CIE's estimate using GTAP of a 0.34 per cent increase. ACIL estimates that Australian GNP falls by 0.09 per cent while consumption drops by 0.05 per cent; export volumes rise 1.48 per cent while import volumes increase 1.3 per cent. ACIL says these results are driven mainly by trade diversion, especially from Asia, and by an adverse movement in Australia's terms of trade with the rest of the world (the ratio of prices Australia receives for exports against prices paid for imports) as the expansion in Australian exports depresses prices on world markets. DFAT representatives on a steering committee overseeing the ACIL research for the RIRDC were so unconvinced by these numbers that they sent the report back for more work. Passions ran high among the pointy heads. ACIL would not budge on its results. Eventually the report was released publicly but without RIRDC's imprimatur.* The article is noteworthy for not dumbing-down the issues. When was the last time you read about Armington elasticities in the mainstream press? It is a shame then that the author feels the need to distance himself from his subject with gratuitous references to ‘pointy heads.’

posted on 7/22/2003

The protagonists in the debate over an Australia-US FTA

are nicely surveyed in this article in the *AFR*. Alan Oxley's views get a welcome airing: *Oxley reckons the opposition to the FTA from Garnaut and his colleagues at the ANU's Australia-Japan Research Centre is politically motivated by their support for Australian economic integration with Asia. "One can deduce from the arguments of the Asian integrationists that the political goal of building relationships with East-Asian governments might have a higher priority than enhancing national economic welfare," Oxley wrote in a rejoinder to Garnaut. "It is not in Australia's interest to seek to direct trade and investment growth towards any region for political reasons if there is an economic cost. "It is in Australia's interests to encourage economic integration with markets in all major regions. One reason the Asian economic crisis did not [have a significant] impact on Australia was the importance to Australia of trade and investment with the rest of the world." Oxley says the other main source of mainstream economic opposition to the FTA comes from "monoline multilateralists" - trade experts who fret that a proliferation of regional free trade agreements is undermining the multilateral system. But he says these critics have got the direction of causation wrong in their analysis of the impact of regional agreements on multilateral liberalisation - that it is the growing failings of the multilateral system which have fuelled the popularity of regional agreements in recent years, rather than the other way around. "Now that the WTO is so large [there are more than 140 members] and the range of issues covered is so wide, the process of liberalisation in the WTO is even more difficult and slow. "In the Uruguay round it was not until about a decade after the negotiations began that countries started to enjoy the economic benefit of the agreements reached. "Gains can be secured more swiftly through bilateral or regional agreements."*

posted on 7/21/2003

Alan Kohler

continues to highlight the problems associated with the larger active fund managers: *That professional fund managers, on average, destroy wealth is not particularly surprising: investment is a zero sum game. For every person who does better than the index, there must be someone doing worse. If mutual funds, as a class, do better than the market, another class is doing worse, and they certainly cannot, as an industry, earn their fees in outperformance unless someone else is losing the same amount...The bottom line is that putting one's money with a "brand based" fund manager, like a bank, in which a large organisation operates an in-house investment bureaucracy, is simply another way of throwing it away.* There are, however, other options. As Kohler points out, one can opt for one or more of the smaller boutique fund managers who do actually try and earn their keep by aiming for absolute performance instead of just tinkering at the margin with the index. But these fund managers often do not take retail clients. The other option is to invest in a low cost, passively managed index fund. As far as I know, Vanguard offers the only retail indexed superannuation product in Australia.

posted on 7/19/2003

Shock, Horror

There is more than one view on the RBA Board: *RBA board member and prominent economist Warwick McKibbin suggested fellow board member, federal Treasury Secretary Ken Henry, might have overstated the risks of a major correction in the US. Professor McKibbin told The Australian Financial Review Dr Henry was unduly focused on US weaknesses, like the huge budget and current account deficits, rather than other problems in the global economy...The difference between the two economic policymakers indicates RBA governor Ian Macfarlane is receiving different views about the global economy, a key factor in the setting of interest rates.* It would be more remarkable, although apparently less newsworthy, if Macfarlane were not receiving different views. If there is a story here at all, it is that the Treasury Secretary, through his ex officio role on the RBA Board, has become the institutionalised voice for easier monetary policy. These are policy preferences that can easily be confused with those of the government of the day and argue against the Treasury Secretary's role in monetary policy decision-making. On the substantive issue in question, the state of the US economy, the NBER's Business Cycle Dating Committee has now determined the US economy experienced a trough in November 2001, highlighting the limitations of the classical approach to business cycle dating. The NBER's Q&A goes on to make the somewhat redundant observation that 'the committee does not forecast or comment on current economic activity.'

posted on 7/18/2003

Former Australian diplomat Peter Gallagher

has a blog on world trade issues that is worth checking out.

posted on 7/17/2003

Picked-up the latest Cambridge University Press

economics catalogue at last week's Australasian meetings of the Econometrics Society. Tip for CUP: if you want to sell books to economists, try publishing more books that are not completely hostile to economics. Michael Pusey's latest features on the front page of the 2003 catalogue and includes this endorsement from Australian Greens leader Bob Brown: *Michael Pusey and his team have unveiled a fascinating insight into the hidden Middle Earth of Australian thinking.* I'm not entirely sure what that means. But like The Lord of the Rings, Pusey's work is perhaps best viewed as an anti-modernist romantic fantasy. The definitive critique of Pusey can be found here.

posted on 7/17/2003

Hayekian Moments

Australian fruit induces a Hayekian moment in Brad de Long. We need to export more of that stuff.

posted on 7/17/2003

Alan Greenspan's
testimony all but rules out the need for quantitative easing: *The Federal Reserve has been studying how to provide policy stimulus should our primary tool of adjusting the target federal funds rate no longer be available. Indeed, the FOMC devoted considerable attention to this subject at its June meeting, examining potentially feasible policy alternatives. However, given the now highly stimulative stance of monetary and fiscal policy and well-anchored inflation expectations, the Committee concluded that economic fundamentals are such that situations requiring special policy actions are most unlikely to arise. Furthermore, with the target funds rate at 1 percent, substantial further conventional easings could be implemented if the FOMC judged such policy actions warranted.* At the same time, the BoC has moved back into easing mode. The BoJ, however, has decided to keep policy unchanged with minimal deliberation, concluding its policy board meeting at 10:40am rather than the usual 1pm or later.

posted on 7/16/2003

Niall Ferguson and Laurence Kotlikoff
on the bond market implications of the 'latent fiscal crisis of the US welfare state:' *But investors cannot afford simply to go into denial. One possible inference might be that future federal deficits are likely to be larger than forecast and that this spells the end of the recent bond market "bubble". After all, a widening gap between revenues and expenditures is usually filled either by selling more bonds or by printing money. Either response implies a decline in bond prices and hence a rise in long-term interest rates.* And to think that just a few years ago people were forecasting fiscal surpluses without end and the demise of sovereign debt markets.

posted on 7/15/2003

The debate over multilateralism versus bilateralism in trade negotiations
poses some interesting questions for those who subscribe to the classical case for free trade, which is dismissive of the notion of reciprocity as a prerequisite for trade liberalisation. It is easy to be dismissive of both multilateral and bilateral trade liberalisation processes. Nonetheless, many classical liberals have some sympathy for bilateralism as a second-best approach to trade liberalisation. This reflects widespread disaffection with multilateral trade liberalisation processes and a view that bilateral agreements might yield more tangible results. But it is difficult to generalise, since any proposed agreement needs to be assessed on its merits. An Australia-US FTA has enormous potential, but early reports of the negotiating process suggest that the agreement might fall well short of that potential. For example, there are indications that ministerial vetoes on undefined national interest grounds will be retained in relation to foreign direct investment, rather than subjecting FDI to the rule of law. Subjecting the market for ownership and control of equity capital to the rule of law is potentially a great normative benefit from such an agreement. It is also a benefit generally ignored in attempts to quantify the implications of such agreements, not least because it is something that defies quantification. It is also clear that many of the defenders of multilateralism are no friends of free trade. This op-ed by Jagdish Bhagwati and Arvind Panagariya is a case in point. Bhagwati's credentials as a free trader are questionable, because of his long-standing advocacy of capital controls. This is

part of what Bhagwati objects to in relation to the US-Singapore negotiations: *In the free trade agreements with Chile and Singapore, the US Treasury insisted on inserting a ban on the use of capital controls, even though the International Monetary Fund has finally come round to the view that they might, on occasion, be justified. Chile and Singapore finally gave in, agreeing to a dispute settlement and compensation mechanism in case the controls were used. Washington has created another precedent.* Indeed it has. And the IMF is being increasingly unfaithful to its own Articles of Association on this score. With friends like these, multilateral trade liberalisation processes are in serious trouble.

posted on 7/14/2003

Conference Time

The School of Economics at UNSW is playing host to a couple of conferences this week. The 11th Australian Colloquium of Superannuation Researchers looked at Retirement Provision in Scary Markets. I was a discussant for what became known as the 'scary countries' session, featuring Brazil and Japan. The other conference is the 2003 Australasian Meetings of the Econometric Society, the full papers for which can be found here.

posted on 7/11/2003

Visiting Nobelity

Daniel Kahneman, Eugene Higgins Professor of Psychology and Professor of Public Affairs in the Woodrow Wilson School at Princeton University and last year’s Nobel Laureate in economic science will be giving a free public lecture at UNSW on Monday. The subject is Toward a Science of Well-Being. Monday 14 July, 6.30pm - 7.30pm, Sir John Clancy Auditorium.

posted on 7/10/2003

Contrarian Indicator Alert

The *AFR* is beginning a series on the realignment in global currencies. According to Peter Hartcher: *Every decade or so, all the countries of the world, and everything in them, go through a major repricing as the world's currencies rearrange themselves in great tectonic movements...all the evidence is that we have entered the early phase of one of the grand realignments when the competitiveness of nations and the future of industries is put into flux.* Putting aside the hyperbole, Hartcher seems to view currency realignments in largely mercantilist terms. You get very little sense from the article that currency realignments might actually help equilibrate global trade in goods, services and capital. Instead, it's all zero-sum, beggar-thy-neighbour. Then there is this: *there is nothing scientific about the way that foreign exchange rates move. Once a trend builds speed, it can roll on juggernaut-like in defiance of all reason.* It's called a random walk with drift. The apparent failure of exchange rates to reflect 'fundamentals' is a reflection of their efficiency, not their irrationality.

posted on 7/9/2003

Melvyn Krauss
says that the FOMC is starting to make the ECB look good, in light of recent price action in global bond markets: *the frequent attacks on the ECB and Mr Duisenberg in both the markets and the media have often had as their implicit assumption the view that the Fed would do it better. This was always unfair. But now we know that it was untrue as well.* Similar arguments are being made in Australia in relation to the RBA, after its most recent Board meeting left policy unchanged. RBA Governor Macfarlane had previously indicated a predisposition to ease. Of course, what he did not say was when! **UPDATE:** Governor Macfarlane's BCA dinner speech has avoided making any further comment on current policy. As Macfarlane notes, any comments he might make 'would run a great risk of destabilising a basically stable situation.'

posted on 7/8/2003

Samuel Brittan
casts another critical eye over the deflation debate: *To raise the alarm about possible German deflation, because the rate of inflation in that country has fallen to 0.6 per cent - against a euro area rate of 1.9 per cent - is simply to ignore the advent of the new currency. To talk about German deflation makes as much sense as to talk about deflation in Texas or Cornwall, unless you believe monetary union is premature or still immature... Would you rather have a 4 per cent increase in output offset by a 1 per cent fall in prices? Or no increase in output but a 3 per cent rise in prices? The deflation-mongers implicitly assume the latter outcome would be better because there is a positive rate of inflation.*

posted on 7/5/2003

Alan Reynolds
fisks the latest statement from the FOMC: *Congress gave the Fed enormous power to mess things up but no mandate about what the central bank's goal should be. Lacking any legitimate job description, the dozen members of the Federal Open Market Committee (FOMC) came to think of themselves as expert central planners in charge of fixing whatever problems they could dream up. At this moment, the FOMC central planners proclaim the economy "has yet to exhibit sustainable growth." From the fourth quarter of 2001 through the first quarter of this year, the economy grew at an annual rate of 2.7 percent. That was slow, but there is no evidence to suggest it was not or is not "sustainable."... In reality, the headline statement about growth not being sustainable meant nothing at all. "The committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal." That is, the FOMC thinks the economic growth -- which has heretofore been unsustainable -- is nonetheless likely to be sustained. And it boldly forecast a 50-50 chance that things could get better or worse... The Fed has given itself too many chores over the years, which makes it less likely it will do any of them very well. It is up to Congress, not the Fed, to reduce tax and regulatory obstacles to economic growth. That will make the Fed's job easier because additional supply, innovation and productivity help to hold inflation down, contrary to Fed dogma. It is also up to Congress to give the Fed a clear assignment -- to keep some acceptable measure of inflation within a narrow range.*

posted on 7/3/2003

The Martin Place Commentariat

are lining-up against an RBA rate cut at tomorrow's post-Board meeting announcement window. Alan Mitchell, Dave Bassanese and Alan Wood are suggesting that the balance of risks favours a steady policy outcome. More interesting though is the market reaction to these comments. Alan Mitchell's article, in particular, is being credited with moving markets overnight. And Alan Wood has this extraordinary remark in his article: *Just to avoid any unseemly market action today, let me make clear this conclusion is based on the above analysis and is not a secret signal from Martin Place.* What Alan Wood is effectively saying is that there is a widespread belief in the market that the RBA backgrounds certain economics writers about likely policy outcomes. There is certainly some evidence to suggest that this has occurred in the past. Especially during the course of 2001, there were a number of instances when the statements accompanying RBA policy actions were anticipated with startling accuracy in the columns of a couple of economics writers. One would hope that this practice has been discontinued. However, as Wood's comment indicates, there is still a perception that the RBA engages in such backgrounding. As for what the RBA will do tomorrow, I still maintain the RBA is much more likely to ease than not. **UPDATE:** The pundits were right. The RBA has left the official cash rate unchanged at 4.75%.

posted on 7/1/2003