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Articles for the Month:

Non-Solutions to a Liquidity Trap

GFC Economics partner Graham Turner has an op-ed in the *FT* summarising the argument from his book *Solutions to a Liquidity Trap*. The op-ed makes some extraordinary claims about the efficacy of monetary and fiscal policy in Japan. Turner claims that: *GFC Economics, with the help of a simulation run by Oxford Economic Forecasting, has shown that it would not have taken much for the BoJ to have prevented debt deflation from taking hold. By not raising the discount rate during the year of the crash, and then starting the process of easing just six months earlier, a decade or more of economic decline in Japan could have been avoided... If the BoJ had simultaneously initiated a policy of quantitative easing and stopped the yield curve from steepening, deflation could have been averted.* It is difficult to evaluate this conclusion without looking at OEF's methodology. But it begs the question as to why the quantitative easing approach that Turner now advocates for the Fed has failed to produce these results since it was implemented in Japan in March 2001. The book synopsis on the GFC Economics web site suggests the author has a misplaced faith in the efficacy of discretionary macro policy at the expense of structural reform: *Corporate restructuring and supply-side economics have little to offer once an economy has slipped into a liquidity trap. In Japan's case, it seems that only large-scale nationalisation of the financial sector and possibly many of its ailing companies will suffice. A wages policy may also be required. Many of these solutions are alien to a world that has become increasingly wedded to an ideology of free market reform.* If there were a simple and painless macro policy formulation to Japan's problems, the authorities would almost certainly have exploited it. Zero nominal interest rates have an important structural component. It is amazing that a City of London financial markets consultancy should be so wedded to such an interventionist world view. **UPDATE:** Dr V is also unimpressed with Turner's arguments for quantitative easing.

posted on 6/30/2003

P.J. O'Rourke

reviews that book: *Boring others is a form of aggression, and Hillary attacks her public with the weapon of brutal dullness.*

posted on 6/29/2003

A New RBA Easing Cycle?

For those who have been asking, yes, I do think the RBA will ease next week (by 25 bps) and the accompanying statement should be good for a renewed front-end rally. It is not a big call to suggest that the previous easing cycle low will be revisited. The RBA's concerns about the housing sector should be viewed as symptomatic of its long-standing paternalism, rather than a major consideration for monetary policy as such.

posted on 6/27/2003

Economists and Their Dogs

Greg Mankiw is just a front for the real power behind US economic policy - who else but Keynes! Of course, what US economic policy really needs is to have a cat-person in charge.

posted on 6/27/2003

Gerald O'Driscoll

is beating the inflation drum in the wake of this week's Fed easing: *In the end, financial markets may negate the beneficial effects for economic activity of the Fed's expansionary monetary policy. If markets are in fact turning their attention to the possibility of inflation, long-term interest rates will rise. Higher interest rates offset the effects of monetary stimulus. Perhaps that will yet give Fed policy makers pause. For now, however, higher inflation is in store for the US economy. Global investors take note.* The OECD's chief economist has been telling Japan to make more active use of monetary policy, saying that 'the main task of fiscal policy is to restore sound government finances.' The MoF must have got to him first. For its part, the BoJ kept policy steady following this week's policy board meeting, the first steady policy outcome under Governor Fukui, so one can hardly say policy has not been 'active' under the new Governor. The overnight call rate in Japan has finally fallen to an average below zero, indicative of the extent of foreign bank activity in the market at the present time.

posted on 6/27/2003

Barry Hughes

argues that the joint rally in US stocks and bonds can be rationalised with reference to USD weakness: *Profits are hugely leveraged to the business cycle, so that even the limp US recovery so far has managed to generate double-digit growth in after-tax corporate results And the usual cyclical relationships suggest that a mere 3 per cent GDP pace, about what the pundits are predicting, should continue to generate profit gains in double digits for a while. The second, third and fourth answers have to do with different aspects of the de-bubbling of the dollar. By far the worst period for US profits were not the recession eras of 1982 and 1992 but the cyclically ordinary year of 1986. That coincided with the peak of greenback mania, which put profits through a currency shredder. US producers stayed in the game, as they did in the recent lesser greenback mania, slashing profit margins in the hope that currency monsters would eventually depart. They did, and are now doing so again, allowing US profit margins to recover independently of the GDP cycle.* If you can make a US optimist out of Barry, it's time to get on board. Desmond Lachman has a suggestion that would help speed the global adjustment process. He wants the IMF throw the book at the authorities in a number of Asian countries who engage in routine currency intervention: *The International Monetary Fund does have explicit provisions against currency manipulation.*

Indeed, Article 4 of its Articles of Agreement obliges member countries "to avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members". Since 1979, the IMF has also had a separate surveillance procedure whereby its managing director can institute ad hoc consultations for countries suspected of manipulating their exchange rates for competitive advantage. However, there have been only two such consultations on currency manipulation - one for Sweden in 1982 and one for South Korea in 1987 - and each conveyed only mild criticism. While a blind eye could be turned to currency manipulation in the buoyant years of the 1990s, there should be little tolerance for free-riding in today's more difficult global environment. Each country should be required to bear its fair share of the adjustment in the US's external accounts. Don't hold your breath waiting for the IMF to act.

posted on 6/25/2003

Happy Birthday GST

Ross Gittins is commemorating the birthday of the GST, noting: *despite all the other fancy justifications we were given, the real motive for the GST was to strengthen governments' revenue-raising capacity. And it's worked a charm.* But surely Ross is not complaining? After all, he has been advising the ALP to go for broke (literally?) and throw the recent tax cut billions at public schools and hospitals. Any one who wants to underwrite failed non-price rationing systems for the public provision of private goods cannot complain about higher taxes.

posted on 6/25/2003

Global Disinflation

A new BoJ research paper applies the methodology developed by Kamada and Hirakata (2002) for decomposing Japan's inflation rate into cyclical demand shocks, productivity shocks and the global supply shock associated with the expansion of capacity in emerging economies since the mid-1990s. The new paper extends this approach to recent inflation outcomes in a number of countries, including the US, demonstrating the important role of this global supply shock to inflation outcomes. The extent to which these structural shocks adversely affect economic performance is closely related to the degree of structural flexibility in the economy and the exchange rate regime, hence the pronounced deflationary episodes in Japan and HKSAR, respectively. The policy implication is that structural flexibility, rather than demand management, is an essential part of any policy response to deflation. The BoJ has an obvious agenda in all this, namely to stress the limits of monetary policy in the current environment. But the BoJ is correct to emphasise the significant structural influences on recent global inflation outcomes.

posted on 6/23/2003

Frederic Bastiat Prize for Journalism

details of the 2003 competition are available at the International Policy Network site. Deadline 30 June.

posted on 6/23/2003

When Harry Met Hillary
from who else but the incomparable Mark Steyn.

posted on 6/22/2003

Samuel Brittan
is critical of the UK Treasury's attempt to revive activist fiscal policy through an output gap target to offset the demise of monetary policy in the event of euro entry: *Behind the technical discussion there is a more human point. It is what Friedrich Hayek called in his Nobel Prize Address, "the pretence of knowledge". By pretending we know more about the characteristics of the economy than we really do we actually throw away the more modest improvements which our limited knowledge makes possible. It took us the closing decades of the 20th century to learn this lesson; I hope we do not spend the first few decades of the new century in unlearning it.*

posted on 6/21/2003

Andrew Norton
on the Federal government's proposed partial de-Stalinisation of Australian higher education.

posted on 6/21/2003

A major contrarian indicator
gives a buy signal on equities. **UPDATE:** Steve Antler decomposes Krugman.

posted on 6/20/2003

The classical business cycle
The NBER's Business Cycle Dating Committee is still waiting to declare an end to recession in the US: *The committee will determine the date of a trough in activity when it concludes that a subsequent downturn would be a separate recession, not a continuation of the recession that began in March 2001, and has sufficient information to identify the month of the trough. The trough date will mark the end of the recession. The committee waits for many months after an apparent trough to make its decision, because of data revisions and the possibility that the contraction could resume. For example, the committee waited until December 1992 to announce that a trough had occurred in March 1991.* You would not want to be waiting on the NBER before reducing your bond holdings. The Australian economy, by contrast, is still powering along, despite speculation of a renewed easing cycle. The last classical cycle trough in Australia was in 1992.

posted on 6/19/2003

Robert Solow
on deflation fears in the US: 'a diversion and a waste of time.'

posted on 6/16/2003

Australia and Foreign Direct Investment
Australia has the fifth most restrictive FDI regime in the OECD, according to a new OECD Working Paper. Unfortunately, the extent of ministerial and bureaucratic discretion over the ownership and control of equity capital in Australia does not get nearly enough critical scrutiny.

posted on 6/14/2003

Peter Ruehl

spills the beans on the *Financial Times*: *I was contacted by a Financial Times correspondent for a story she was doing on Howard and gave my remarks, which were reported accurately. She described me as a "conservative commentator". I had two problems with this, the first being the conservative part, and the second being that if you regard this as "commentary" you need about 12 more beers. If somebody wants to whack a label on me, that's their business, but she gave herself away by also quoting Robert Manne, to whom she gave no ideological description at all. I like ol' Robert and enjoy his columns, but face it, he's so left that he and Noam Chomsky could operate their own space station. He should have been identified as such. What you don't read can't hurt you.*

posted on 6/14/2003

Oxblog's Political Theory Pick-Up Line Competition

the results are in. In my view, Dan Drezner has the winning line from who else but Adam Smith: *Virtue is more to be feared than vice, because its excesses are not subject to the regulation of conscience. So let us go now, you and I, and test our consciences to their fullest extent.*

posted on 6/13/2003

Alan Mitchell

once again invokes the classical case for free trade against the pursuit of bilateral trade agreements. In fact, the classical case for free trade also argues against the pursuit of multilateral agreements. Many of the criticisms levelled against an Australia-US FTA, for example, can also be made against multilateral agreements, which quickly degenerate into a lowest common denominator negotiating process. Mitchell nonetheless puts forward a unilateral liberalisation agenda that has considerable merit: *What does that mean in practice? It certainly means the government should cut the tariffs on textiles, clothing and footwear and motor vehicles. But the government should also be prepared to review non-tariff barriers to investment and the trade in services as well as goods. These include such sacred cows as the pharmaceutical benefits scheme, the quarantine laws, government procurement schemes, statutory marketing, anti-dumping protection, broadcasting content and ownership regulations and the Foreign Investment Review Board.* An important part of the argument for an Australia-US FTA is that it would subject some of these areas, most notably foreign investment, to the rule of law, rather than ministerial and bureaucratic discretion.

posted on 6/11/2003

The zero bound on nominal interest rates

is increasingly being breached in Japan, according to the [Nikkei](): *Overnight call money transactions are believed to have declined Tuesday. Also, the market saw a transaction with a negative 0.03% rate. As a result, the weighted average rate was zero percent for the second straight day. Transactions carrying negative rates -- an abnormal situation in which a lender pays a borrower interest -- are being conducted in the call market entirely by foreign banks. They can take yen funds procured through currency swaps at even lower negative rates, so these banks are able to lend out their excess funds at negative rates in the money market without taking any losses. "Foreign banks are able to increase their transactions at negative rates as much as they want. Therefore, so it is not hard for the weighted average rate to fall into negative territory," according to an official at one foreign bank that is lending its funds at negative rates.*

posted on 6/11/2003

Business Week

has a story on blogs. Nothing new, except that *Business Week* has long been one of my favourite contrarian indicators. Does this mean that the blog wave has peaked? The article does in fact sound a cautionary note, in sharp contrast to the blogosphere's overplaying of its role in the Howell Raines resignation.

posted on 6/11/2003

The euro: 'born to die'

The UK's decision on euro entry is in. The *FT* has a summary of the 18 Treasury studies on euro entry. At the same time, the *Torygraph* interviews former Bundesbank director Wilhelm Nolling, who has this to say: *But the whole system could eventually collapse, given the problems when one central bank has to steer an entire continent of nation states. Certainly, the more countries that join, the more ungovernable it will become. In that sense, the euro was born to die.*

posted on 6/10/2003

Alan Reynolds

points to the inconsistencies involved in worrying about a falling USD and deflation. He suggests that investors are taking a contrarian view: *The only reason the 1997-2002 deflation scare still sells papers is that the word was dropped by the Fed in early May and the International Monetary Fund more recently. Given the forecasting record of the IMF, Fed and Mr. Krugman, when they start worrying about deflation, investors start betting on inflation. An executive at TIAA-CREF tells me their most popular fund is inflation-protected bonds, and gold is up about 16 percent over the past year. Deflation scares for the United States are quagmire quackery.* Assuming, however, that the Fed is right, its proposed solution, buying long-term bonds, raises as many questions as it answers. Alan Ruskin of 4Cast reminds us of some of the problems inherent in any attempt by the authorities to control long-term bond yields: *When the market does not want to purchase treasuries, Mr Greenspan could commit the Fed effectively to capping yields by acting as buyer of last resort. But for this to be effective for more than a short period, the market has to be convinced the Fed stands to see the capping process through the maturity of the long-term bonds it wishes to target. Barring such a commitment, the Fed will inevitably become a victim of its own success. This is because the more credible this unorthodox reflationary policy, the more it tends to place upward* *pressure on long-term yields. It would then be a case of policy-makers succeeding in the technicalities only to fail in the broader objective.* Ruskin suggests that: *For a central banker with as much respect for market forces as Mr Greenspan, the mere thought of tampering with the treasury market in this way must be a sacrilegious act. It is either testimony to how far the challenges facing the US economy have changed, or it is confirmation of a post-bubble monetary policy careering out of control.*

posted on 6/9/2003

Lunch with Milton Friedman
The *FT* reports on its lunch with Milton Friedman, who is predicting the demise of the euro in 10-15 years and is advising the UK to stay out. I'm surprised Milton is giving the euro 10-15 years. I would give it no more than five. Friedman's essay on the case for flexible exchange rates, published in 1953, is deservedly a classic. The FT's lunch reminds me of an anecdote from Charles Murray, who once took Friedman to lunch and having paid the bill, suggested that there was such a thing as a free lunch after all. Friedman shot back that it wasn't free, because he had to listen to Murray.

posted on 6/7/2003

The debate over intellectual property rights
has a new battle-ground: Kylie's bum. Intellectual property?

posted on 6/7/2003

The story of how NYU is ramping up its economics department
is the subject of this *NYT Magazine* profile, including the details of how they snared Thomas Sargent. Jeffrey Sachs' $8 million townhouse also gets a mention. Who said there was no money in development economics?

posted on 6/7/2003

RBA Governor Macfarlane's
testimony before the House Economics Committee this week showed a welcome degree of frankness about the extent of policy conflict between the RBA and Treasury over monetary policy. Macfarlane stressed that such conflict is routine: *This is quite a common event, it happened quite a lot during 2000-01. It's happened under all secretaries of the Treasury and governors of the Reserve Bank.* By getting such conflict out into the open, Macfarlane is helping to avoid a repeat of previous episodes when such conflict was leaked, which only encourages journalists to blow the conflict out of all proportion, because they think they are sitting on some incredible scoop about the inner workings of the Reserve Bank. This is why minutes of RBA Board meetings and a record of the vote should be published immediately following each meeting. At the same time, Macfarlane's comments call into question the role of the Treasury Secretary as an ex officio RBA Board member. If what Macfarlane says is true, then the current arrangements for monetary policy governance have effectively institutionalised political pressure on monetary policy from Treasury. Macfarlane's testimony is further evidence in favour of abolishing the Treasury Secretary's ex officio role on the RBA Board, as part of a wider restructure to institute a professional MPC-style decision-making body for monetary policy. Macfarlane's testimony was also welcome in that it suggests that the RBA is making greater use of official statements and testimony to communicate its policy bias. Hopefully, this will see an end to the days when we had to read Ross Gittins' column to learn of changes in policy bias.

Speaking of Ross, he is currently engaged in a journalistic cage-match with Brian Toohey over the Treasury's currency swap transactions. According to Toohey, Gittins said 'if you think you've got me over a barrel, go your hardest.' This was after Gittins demanded that Toohey and others eat humble pie on the issue. I'm agnostic on what I think is something of a non-issue myself. But one can't help but feel that there is something more going on between Toohey and Gittins than just an argument over currency swaps.

posted on 6/7/2003

Blogs in 2004

this article is predicting that blogs will be hugely influential in the 2004 US Presidential election campaign: *When the blogosphere ignores a story, that story is marked as boring or insignificant or both. If a story cannot hold the interest of the web's news hounds, it is hardly likely to interest the general reading or viewing public. If the web seizes on a story, however, it is a huge signal to editors and assignment desks to pay attention. The media dinosaurs can ignore these currents in opinion-making, of course, but not for long. The first presidential election with full blog participation is opening now. As the Iowa caucuses approach, watch the blogs (1) to see if any Democrat is catching fire there and (2) for leaks of damaging info. Howard Dean is reported to be investing heavily in controlling web-spin, but the blogs cannot be controlled in any meaningful way. The filters that reporters and producers used to provide are gone, destroyed by free agents in cyberspace.* There is similar potential in Australia, where there is considerable dissatisfaction with the manner in which the parliamentary press gallery reports on federal politics. The gallery almost single handedly (and, needless to say, inadvertently) re-elected the Howard government with the enormous prominence it gave to a certain issue in the final days of the last federal campaign. But it is far from clear that any of the established Australian bloggers are interested in full-time election coverage. Many in the US are attributing the resignation of Howell Raines to pressure exerted from the blogosphere. There is much exaggeration in this, since the pressure from other stakeholders would have been enormously greater than anything the blogosphere could bring to bear. An interesting question is whether the change at the top will bring an end to the Krugman Rhetorical Inflation Cycle. The Krugman On-Line Truth Squad, led by Don Luskin, would certainly be claiming credit in that eventuality.

posted on 6/6/2003

Alan Kohler

on the political economy of John Howard's Prime Ministership: *Appear conservative...while at the same time increasing taxes on those whose votes don't change (the rich and the poor) and giving the money to those whose votes do change - the middle classes. In some ways, John Howard is actually a true conservative - that is, anti-change. His main claim to radicalism - tax reform - was actually an exercise in administrative maintenance: tightening the nuts and bolts of the tax system...But then again, the general level of taxation is higher than it was before John Howard came to office and overall spending has not been cut. John Howard is a big taxing, big spending conservative.* Not that the opposition would be any better. Meanwhile, John Stone wants ten more years. I doubt Stone really believes that. He just enjoys demoralising Howard's enemies. While on the subject of politics, don't miss

Oxblog's competition for the best (or is it the worst) political theory pick-up line. The great thing about being an economist, of course, is that we get to do it with models.

posted on 6/4/2003

Arnold Kling

in his latest TCS column, questions the extent to which economic performance in the US should be attributed to the actions of government. He links to a couple of interesting papers from a recent KSG Conference on American Economic Policy in the 1990s.

posted on 6/3/2003

Scholar bloggers

are profiled in this article from the *Chronicle*, including this interesting observation from one such blogger: *"I've certainly changed my picture of what libertarians are like," says Chris Bertram, a senior lecturer in philosophy at the University of Bristol, in England, whose blog persona is "Junius." Mr. Bertram, a social democrat, says that he and his fellow political philosophers sometimes suffer from a constricted field of vision, with "all kinds of received opinions that just aren't shared by most other people." Mr. Bertram says that debates with other bloggers have taught him that many libertarians do not follow Robert Nozick's philosophical principles, but instead favor markets "for other, basically more pragmatic, reasons." He adds, "There's been a mildly rightward pressure on my politics."* There is hope for John Quiggin yet.

posted on 6/2/2003