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Articles for the Month:

Joe Stiglitz

has the oldies keeling over in their pews: *As Stiglitz finishes speaking, and the applause dies down, I notice that one of the pensioners behind me has quietly nodded off. "Would you like to go home for a nap now dear?" asks his wife. The disciples of Joseph Stiglitz may be grateful for what he has to say. But apparently not all of them have the stamina required to hear him say it.*

posted on 5/31/2003

Ben Bernanke's

speech before the Japan Society of Monetary Economics in Tokyo was distressingly predictable. Bernanke calls for price level targeting and yet more monetary accommodation of fiscal stimulus, alongside some rather token calls for structural reform. Bernanke suggests that a tax cut funded by BoJ government bond purchases would get around the broken monetary policy transmission mechanism, without having offsetting adverse wealth effects on the private sector. This sounds very much like the fiscal theory of the price level. In a liquidity trap environment, monetary policy becomes endogenous, so fiscal policy becomes dominant by default. Bernanke is thus wasting his time lecturing the BoJ. He needs to convince the MoF, who remain firmly wedded to fiscal consolidation, not further fiscal stimulus. It is tempting to view Japan as an epic example of failed macro policy coordination. Yet this coordination failure is a large part of what keeps the pressure on the government to maintain its reform efforts. The LDP old guard see reflation as their best chance of avoiding reform, which is why they too are so keen on monetary and fiscal stimulus. So Bernanke is keeping some pretty poor company. Bernanke's speech was prepared before his trip, and so does not reflect what he might have discovered on his visit to Japan. Hopefully, he will take note that massive growth in base money and central bank purchases of government bonds are not the sure-fire deflation cure he seems to think. **UPDATE:** Have finished reading the report of the IMF's task force on deflation. According to the task force, 'structural reforms should not, however, be regarded as a prerequisite for the monetary and fiscal response [to deflation].' The task force is not talking about Japan specifically, but one assumes the IMF would not view Japan as an exception. One of the criticisms of the IMF is that it is supposedly too hard-nosed on conditionality, yet this is rarely found in their macro policy advice.

posted on 5/31/2003

The Reserve Bank of Australia
frequently intervenes in foreign exchange markets to influence the value of the Australian dollar, the world's seventh most actively traded currency. A large part of the rationale for such intervention is that it is designed to smooth volatility in foreign exchange markets. Such government intervention would be considered highly dubious in any other asset market, but foreign exchange markets are seen as a special case, perhaps because of the widespread belief that they overshoot (there are some well known formal models illustrating this idea). However, there is also a minority view that such intervention actually destabilises markets, by increasing uncertainty and volatility. A new IMF paper suggests that this might the case for RBA intervention in the Australian dollar (see also this recent RBA RDP on the issue). The IMF paper also makes this extraordinary claim about how intervention might work: *By raising market uncertainty, intervention would increase the risk associated with taking a large open position in the exchange market, and thereby, force market participants to reconsider their positions.* The suggestion that reducing liquidity through increasing uncertainty could be stabilising for the market is dubious to say the least. Uncertainty about intervention increases risk for both sides of the market.

posted on 5/30/2003

Shutting Krugman's Liquidity Trap
Arnold Kling puts forward the idea of a 'statist trap' to explain Japan's economic malaise. This increased emphasis on real economy solutions to Japan's problems is to be welcomed. Meanwhile, Paul Krugman's chief on-line stalker, Don Luskin, has taken-up Krugman's latest *NYT* missive under the headline 'shut your liquidity trap.' As readers of this blog will be aware, I don't share Luskin's belief in naïve monetarism as a universal solution to deflation. As Japan's case dramatically illustrates, massive growth in base money and central bank buying of government bonds does not necessarily bring an end to deflation. The quantity theory has other parameters that need to be considered and deflation may have an important structural component. Luskin suggests that Krugman is ignoring this monetarist prescription in favour of excessive emphasis on the zero bound in nominal interest rates. Krugman's (1998) paper in fact sought to show how the long-run neutrality of money might fail as a result of deflationary expectations. Of course, Krugman failed to actually look at the data on inflation expectations in Japan, which does not support this interpretation. Krugman also glossed over the mechanisms by which positive inflation expectations might be generated. But one of his suggestions was for monetary accommodation of fiscal stimulus (ie, central bank purchases of government bonds). Luskin sees this as a failure on the part of Krugman to acknowledge that there is a ready way out of the liquidity trap. But it also shows that Krugman and Luskin are essentially on the same page in terms of their policy prescription to deal with deflation, a prescription which the Japan case shows to be ineffective in some situations. I think the main problem with Krugman's (non-populist) work on this issue is that he seems to have walked away from what was a promising attempt to give modern micro-foundations to the traditional Hicksian idea of a liquidity trap and reverted back to an IS-LM framework that it is hopelessly ill-equipped for the task. As Luskin has sometimes shown, the more popular renditions of his ideas leave much to be desired too.

posted on 5/29/2003

For those who missed it
my review of *The Ordinary Business of Life*, by Roger Backhouse, is up at the CIS *Policy* website.

posted on 5/28/2003

Tudor Investment Corp economists Robert Dugger and Angel Ubide
have produced an interesting paper that postulates the existence of a 'structural trap' as the real economy counterpart to the much abused liquidity trap concept. Their paper was presented a year ago and got a mention in the most recent *Economist* survey of the world economy. But the 'structural trap' idea deserves wider currency. Dugger and Ubide do not formalise the idea, except in rather unsatisfying IS-LM terms. But its chief value is perhaps as a useful rhetorical short-hand for the argument that underlying structural issues need careful attention in the context of arguments about the appropriate policy response to deflation, especially in the case of Japan. The authors' argument essentially echoes that many of us advanced to rationalise the BoJ's August 2000 tightening in monetary policy. Easy monetary policy introduces moral hazard into the structural reform process and delays the reallocation of labour and capital necessary to end excess capacity and deflation.

posted on 5/27/2003

Stephen Cecchetti
has a useful suggestion for reformulating USD 'policy:' *So the next time Mr Snow is asked about the dollar policy - which he will be - this is what he should say: "Day-to-day fluctuations in the value of the dollar are determined in financial markets. Our goal is to implement policies that ensure high and stable growth, so that the US economy continues to be the best place in the world to invest and the dollar remains the pre-eminent currency." If Mr Snow and Mr O'Neill had been saying this for the past two years, would it have made any difference? Would the dollar still have depreciated by 25 per cent against the euro? The answer is probably yes. The dollar's decline is a result of economics, not rhetoric. Mr Snow is clearly right. What the US needs is a fiscal policy that inspires investor confidence. When the country gets it, it will also get a stable dollar.* Cecchetti also hits the nail on the head when he says: *Because he (Snow) is not one of their own, financial market participants and commentators are looking for reasons to criticise him.* Financial markets would much prefer one of their own, because they are easier targets for regulatory capture. Robert Rubin could always be relied upon to bail-out the major investment banks from their bad investment decisions. Cecchetti also reminds us that Rubin's last two interventions in foreign exchange markets were to weaken the dollar.

posted on 5/26/2003

According to the *Financial Times*
deflation 'brought down Weimar Germany.' You can always rely on the *FT*.

posted on 5/24/2003

Another great Robert Feldman post on deflation

explaining why all those editorials in the *FT* and *The Economist* that argue for Japan to just inflate its way out of trouble are so irresponsible: *At least in the case of Japan, velocity has been horribly UNstable. Mere instability is one thing, but in fact, in Japan's case, velocity has been endogenously unstable. Every time the Bank of Japan has printed more money, people just stick the money under their mattresses. In short, M up leads only to V down. The key reasons are worry about the solvency of the financial system, and poor returns in the real economy. Until confidence in financial institutions can be restored, and until resource allocation in the real economy improves enough to pay interest, raising M will not help. This is not to deny that monetarism has its times and places. However, to the extent that other countries suffer from weak financial systems (the US not so much, Europe rather more), monetarism will not work. To the extent that other countries suffer from poor resource allocation (the US to some extent, Europe much more), monetarism will not work.* Calls for monetary and fiscal stimulus in Japan, not least from the US Treasury, the OECD and IMF, simply play into the hands of the LDP old-guard, who argue for macro stimulus at the expense of structural reform.

posted on 5/23/2003

The Reason Public Policy Institute

has just got out of control.

posted on 5/23/2003

Sounds like Stephen Roach

has been getting some tutorials from his colleague, Robert Feldman. How else to explain this generally sensible piece on deflation from Roach? *there is far more to the ability of a central bank to get policy traction than a theoretical linkage between the quantity of money and the prices of goods and services. That's especially the case in a post-bubble US economy that is lacking in pent-up demand in the very sectors that typically respond the most to monetary stimulus — consumer durables, residential construction, and business capital spending. It's also the case in an economy that is feeling the full force of deflationary pressures from the business cycle, the bubble, and globalization. So where does the money go? In an overly-indebted, saving-short US economy, liquidity injections can easily be diverted away from the real economy into balance-sheet repair. The monetarist diagnosis of the causes and cure for deflation sweeps each and every one of these considerations neatly under the rug... For its part, the Federal Reserve has now given up on monetary targeting altogether — no longer providing Congress with projected ranges on prospective growth in the money stock. It is both ironic and puzzling that the same Fed now claims that the monetarist prescription is the ultimate answer to America's deflationary conundrum.* Robert Feldman has been making similar arguments about Japan for years.

posted on 5/22/2003

Catherine Millet is in Australia
for the Sydney Writers' Festival. Peter Ruehl suggests that being French has something to do with it: *in the arts sweepstakes, Catherine's got a few things going for her, the first being she's French. We tend to let the French talk about anything and act as though it's art because that's less scary than what they do with reality. A French person with a typewriter or paintbrush is a lot less dangerous than a French person with an economics degree and diplomatic immunity.*

posted on 5/22/2003

The Treasury Secretary's annual post-Budget address
to the Australian Business Economists has become a noteworthy event under Ken Henry. Last night's address was no exception. Usually, his post-Budget address elaborates on one of the themes in the Budget papers, but in a more pointed way. Henry's theme this year is best summarised in the following passage: *The challenges to our future living standards posed by demographic change will call for many reform initiatives over many years. Indeed, the future economic reform agenda is stacking up every bit as important, and just as extensive, as what has been achieved over the last couple of decades.* There was a time in the 1980s and early 1990s when a speech like this would have generated screaming headlines. The nation's top econocrat is warning that in the absence of further reform, Australia's relative standard of living will inevitably decline. But there now seems to be an enormous amount of public indifference to these issues. As usual, the media coverage focussed on Henry's now almost routine criticisms of financial market participants, rather than more substantive issues. Why talk about serious issues, when there is a good stoush to write about?

posted on 5/21/2003

Samuel Brittan
points to the likely outcome of the UK's euro entry decision on 9 June: *A couple of years ago I suggested that Tony Blair should give the euro a rest for five years, as endless discussion had not achieved anything and merely distracted attention from more important issues. My main hope now is that the whole euro membership issue will be shelved for as long as possible. The Treasury assessment is likely to advocate further examination at a later date. The further ahead this is pushed the less the urgency of a No campaign.* Brittan also has some suggestions that almost sound like free banking: *Why not then shelve the euro issue indefinitely by declaring that British residents are free to use whatever currency they like and let the euro make its way on its own merits?* Unfortunately, most of Europe has already been denied that choice.

posted on 5/21/2003

Norman Lamont

on euro defenestration: *To ask what are the consequences of staying out of the euro is like asking what are the consequences of not jumping out of the window. The consequences are life goes on, we are in quite good shape, and we have avoided a step that would inevitably end in disaster. Having failed to convince the British public of the so-called positive advantages of the euro, supporters of entry now claim that the argument is about the "costs" of not joining the euro. The facts are clear. The British economy has performed better than the euro zone, both since its launch in 1999 and by even more in the past 10 years. Economic growth and jobs creation are rolled into one of the "five tests" that will determine whether the government will recommend we join the euro, and on which British Chancellor of the Exchequer Gordon Brown will rule on shortly. But they must be the key test. And that is the test that Britain "fails", though that is a curious word to describe Britain's superior economic performance.*

posted on 5/20/2003

Japan and Hayek

There is something about Japan that causes people to reach for Hayek. Karel van Wolferen did so in his controversial, *Enigma of Japanese Power*, which was notable for having anticipated many of Japan's current problems when the bubble economy was still at its height. The *AFR*'s Tokyo correspondent, Brendan Pearson, now finds occasion to draw on Hayek's notion of the fatal conceit: *But the sources of Resona's problems, and the malaise afflicting Japan's banking system, run much deeper. The causes can be traced to a Japanese version of what economic philosopher Friedrich Hayek termed socialism's "fatal conceit" - the notion that "man is able to shape the world around him according to his wishes". The conceit in Japan's postwar policymakers was their belief that they could shape capitalism to suit Japan, rather than the other way around. In the banking sector, this was characterised by the creation of the so-called convoy system, in which the banks would move in lockstep. A grand bargain was agreed. Market signals would be smothered, competition muted.* Pearson concludes: *Sometimes Japan's economy looks 100 per cent Marxist - 50 per cent Karl and 50 per cent Groucho.*

posted on 5/19/2003

Deflation concerns in the US and Japan

have been amplified by recent price data, with US producer prices and Japan's GDP deflator posting record declines. This has seen US bond yields at 45 year lows, while in Japan, even the 30 year bond is now below 1%. It is instructive to look behind the headline numbers. In the US context, most commentators have recognised the important role of falling energy prices, which is hardly a cause for concern. In Japan, the record 3.5% y/y decline in the GDP deflator also demands more detailed consideration. The private household consumption deflator (Greenspan's preferred measure in the US) fell a more modest 1.4% y/y, which was actually an improvement on the previous quarter's 1.5% decline. The rate of deflation in relation to household consumption spending has been remarkably steady, suggesting a secular decline rather than a deflationary spiral. The most pronounced falls in Japan's national accounts deflators were in relation to private non-residential investment (-5.2%) and export prices (-5.3%). The persistent decline in the prices of investment goods should hardly be surprising in an economy that is overcapitalised, with a marginal productivity of capital and a real equilibrium interest rate close to zero. The export price deflator is volatile at the best of times, reflecting exchange rate volatility. These are important relative price signals, even if they are contributing to a decline in the absolute price level. The current deflation is not the concern that the headline numbers might be thought to imply.

posted on 5/17/2003

Andrew Norton

on the Federal government's proposed higher education reforms: *An argument in favour of completely deregulating fees is that price caps lessen, but don't abolish, one of the most perverse features of the current system. This is that although for most Australians their own human capital is their most important income-earning asset, university education is one of the very few assets in which investment beyond a government-set amount is effectively forbidden. In Australia's one-size-fits-all higher education system, every student pays the same amount per course, and gets roughly the same service, regardless of learning and career needs and preferences. Under a more flexible system, students can make choices reflecting their personal priorities, not the Commonwealth's budget priorities.*

posted on 5/16/2003

The UK's decision on euro entry

will be announced in the Commons on 9 June. Adding to the case against euro membership, the CEPR has determined that the BoE produces the best inflation report of 19 inflation targeting central banks. The RBNZ, not surprisingly, is number two. The RBA does not rank in the top ten, although perhaps this is because it does not produce an inflation report as such. The RBA's Statements on Monetary Policy tend to be more retrospectives rather than actual oulooks. Unfortunately, experience suggests that if the RBA produced a forecast marginally different from Treasury, there would be hysterical headlines about official sector policy conflict the next day. Also noteworthy is the fact that not even the centre left Institute for Public Policy Research is sold on euro membership at the present time: *The European Central Bank and especially the Stability and Growth pact are real barriers to UK membership.* ***The current UK monetary and fiscal policy framework is superior in many respects****. There is a strong case for allowing individual member states flexibility over how they ensure fiscal sustainability: the UK's current fiscal rules would meet any sensible criteria. However, the UK should not join the euro in the hope of achieving reform from within: this would be taking an unnecessary risk and talk about a 'window of opportunity' is misplaced. Reform is in the interests of all the euro member states: it is not a concession that the UK needs to extract from the existing members.* The admission that the UK's monetary and fiscal policy framework is superior is surely a knock-out blow to UK euro entry.

posted on 5/15/2003

World Competitiveness Ranking 2003

according to the *Nikkei*, Australia has made number two in IMD's World Competitiveness Ranking for 2003. This follows a change in methodology that previously saw Australia rank between 10 and 14. The new methodology splits countries into two groupings based on population size, so Australia just makes the larger country grouping, while a lot of smaller countries previously ranked more highly are relegated to another group. The old rankings made more sense to me than the new. Australia is structurally a lot more like a small open economy than the large, relatively closed economies, such as the US and Japan, that it is now grouped with. The IMD website doesn't have the new yearbook up yet, but is taking orders for a June release.

posted on 5/14/2003

Don’t spend it all at once

The Federal government has delivered a tax cut in its 2003-04 Budget, but the cuts are miniscule by any measure. This highlights the impossibility of a meaningful reduction in the overall tax burden in the absence of fundamental expenditure reform. The only useful purpose the tax cuts serve is to constrain the spending options of the Federal Opposition going into the next election, by keeping the budget close to balance. The politics of fiscal policy in Australia are very different from those in the US, with deficit spending seen as a political impossibility, at least on a projected basis (although the current government has got away with a few deficits after the event and/or on an accrual basis). The government has failed to live-up to its earlier undertaking to keep the revenue share of GDP at 1996-97 levels. Once the revenue from the GST is attributed to the Feds, the revenue share of GDP under the current government is at records highs. Australians still start paying tax at $6,001, not even a subsistence level of annual income and around a quarter of the minimum wage. By the time they are earning $60,001, not much more than average weekly earnings, they are paying 47 cents in the dollar. The tax cuts are an implicit admission of political vulnerability on this issue. The government continues to boast of record spending in areas like health, which only serves to perpetuate the belief that further spending will improve outcomes, making real reform that much harder to achieve. Yet many of the government’s proposed reforms are an implicit acknowledgement that such spending results in an increased misallocation of resources. The proposed changes to higher education fall short of the reforms required to free-up a producer-dominated system run on command and control principles not fundamentally different from a Soviet tractor factory circa 1953. It will be interesting to see if these reforms make it through the Senate. If the Federal Opposition were smart, they would let the reforms through and have the government wear any associated political costs. The budget will see increased speculation of a double-dissolution election followed by a joint sitting of both houses. But we will leave that for a future post.

posted on 5/13/2003

Samuel Brittan

comes out against the UK joining the euro: *My own support for UK membership some years ago was based on the view that it was the one way to ensure an operationally independent central bank. Such a central bank was laid down in the Maastricht Treaty and acceptance of its role was a condition of euro membership. Since the establishment of the Monetary Policy Committee by the Chancellor in 1997 and its relatively successful track record, this particular reason for UK membership has gone.* Brittan also considers the counter-factual situation of a subordinate BoE and finds he would still have major reservations about euro membership in the current environment.

posted on 5/11/2003

Michael Pusey's

latest book on the evils of economic rationalism can be found in extract here, although you will have to pay Australia's leading financial newspaper to read it. By contrast, the capitalists at the Centre for Independent Studies are giving away Andrew Norton's critique. Despite being published in the *Financial Review*, Pusey says that there is an 'army of hit men' out there seeking to discredit his ideas. Fortunately, it doesn't take an army. **UPDATE:** Peter Ruehl joins the army of hit men: *Pusey...describes himself as a middle-of-the road social democrat. He's middle of the road like I'm a cross-dressing Britney Spears groupie.(If you need any clues about where Michael's coming from, check the praise heaped on it by that old leftie American gasbag Noam Chomsky. Noam's a brain cell in search of some company, and he's found it in Michael.)*

posted on 5/9/2003

In the current angst about deflation,

attention remains overwhelmingly focussed on monetary solutions, but with very little attention to possible structural causes. If deflation is ultimately a structural phenomenon, then trying to engineer a fix on the price side may serve to distort some important relative price signals. George Selgin has sought to popularise the view that secular deflation in line with an economy's secular rate of productivity growth is possibly a more appropriate norm for monetary policy than price stability. I would highly recommend the discussion in Selgin's (1999) 'Hayek Versus Keynes on How the Price Level Ought to Behave,' *History of Political Economy*, 31(4): 699-721. It is a remarkable essay, showing how close both Keynes and Hayek came to agreeing on a productivity norm for monetary policy. Japan is an interesting case in this regard. A real business cycle analysis suggests that the slowing in Japan's growth rate can be fully explained by the decline in Japan's productivity growth in the 1990s (see, eg, Prescott and Hayashi (2002)). The decline in productivity growth in turn implies a sharp fall in the equilibrium real interest rate, a key element of Japan's liquidity trap. Raising expectations of future productivity growth is thus more important than raising expectations for future inflation via unconventional monetary policy. Japan has already raised its ratio of base money to GDP to its highest level in a century (ex-WWII) under the quantitative easing approach adopted in March 2001. Yet the Fed seems to think the main lesson from Japan is to adopt unconventional policy measures sooner. If only it were that simple.

posted on 5/9/2003

Dilacerator
has penned a number of good posts on European Monetary Union and associated issues. Check out the 1 May post in particular. Much better than the stuff you read in the *FT*. But before we write-off Europe completely, we should also link to this item about one of the prospective candidates for NATO Secretary-General (cold shower warning for young neo-cons).

posted on 5/8/2003

Some unambiguous signaling from the FOMC on inflation risks:
Although the timing and extent of that improvement remain uncertain, the Committee perceives that over the next few quarters the upside and downside risks to the attainment of sustainable growth are roughly equal. In contrast, over the same period, ***the probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level.*** *The Committee believes that, taken together, the balance of risks to achieving its goals is weighted toward weakness over the foreseeable future.* (emphasis added) With FRB Governor Bernanke having previously flagged the possibility of unconventional monetary policy measures being adopted in this context, it is no wonder the USD correction has gained some additional impetus.

posted on 5/7/2003

Stephen Cecchetti
wants more transparency from the Fed: *Monetary policymakers should not put cameras in the meeting room. But they do need to find a mechanism for giving us a better sense of how they are likely to react to unfolding events. The best solution to this problem is to eliminate the statement of the balance of risks and accelerate publication of the minutes of the meeting. Minutes are anonymous summaries of the arguments made by participants, providing a detailed window into the deliberations. Current practice is to publish them after the following meeting. The minutes of the 18 March meeting will be published on 8 May, after we have read the next FOMC statement. The Bank of England's monetary policy committee publishes minutes two weeks after the meeting, when they can still inform observers about what is likely to occur at the next meeting. Why can the FOMC not do the same?* I think the balance of risks statement is in fact quite useful, although as Cecchetti points out, it can create problems when the Fed then shys away from actually using it. I remember former Australian Treasury Secretary and then ex officio RBA Board member Ted Evans being asked why the RBA refused to release minutes of its proceedings. He suggested that the minutes would make for boring reading. I suspect an important consideration for the government and the RBA is the inability of the Australian media to interpret policy debate in terms of anything other than partisan political conflict. But if other countries can intelligently handle official sector debate over monetary policy, we should be able to do the same.

posted on 5/5/2003

Anatole Kaletsky

puts the US current account deficit in perspective: *America is actually doing the world a favour by buying more goods than it produces...The reason for the US trade deficit is not the profligacy of US consumers, but the stupidly deflationary bias of economic policy in Europe and Japan. The imbalances in the global economy are not the responsibility of Washington but of Frankfurt, Tokyo and Brussels.* This is a little overstated, in that the US did lead the world into recession, but it is certainly true that policies in Europe and Japan have not helped. Kaletsky refers to the 'mismanagement of the euro project,' but the problem is really the euro project itself. The unfolding USD correction has been most pronounced with respect to the euro, which is more of a problem for the eurozone than for the US.

posted on 5/2/2003

Rupert Murdoch

thinks Australian academics should be paid salaries of $1 million. I assume this means Rupert is going to be putting up some of the money. I look forward to holding that future News Corp Chair in Institutional Economics.

posted on 5/2/2003

May Day

Self-styled anarcho-Stalinist Albert Langer has always been one of my favourite lefties and he has an important May Day message: *For more than two decades, the genuine Left has been swamped by a pseudo-Left whose hostility to capitalism is reactionary rather than progressive. The pseudo-Left opposes modernity, development, globalisation, technology and progress. It embraces obscurantism, relativism, romanticism and even nature worship. At May Day rallies, the pseudo-Left whines about how things aren't what they used to be. The real Left has been marginalised, debating neither the neo-cons nor the pseudo-Left, simply because there has been no audience for that debate. Incoherent nonsense from complete imbeciles is published as "Left" comment in newspapers just so right-wing commentators can pretend they have something intelligent to say. In fact "Left" is used as a euphemism for "pessimistic", "unimaginative" and just plain "dull".* He goes on to quote Chomsky in support of George Bush! Read the whole thing, as they say.

posted on 5/1/2003