Recession may have been better than Rudd's economic stimulus

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When I was at school, I studied economics by correspondence. My geography teacher had encouraged me, but because economics was not offered at my school I embarked on the postal system of study.

Looking back, it's quite surprising that I persisted. It was so dry and obscure. We were taught that economics was about scarcity. This was a difficult concept for a 15-year-old to take in. Making choices with limited resources is the best explanation, but that was obviously too straightforward.

One of the most mind-numbing aspects of the course was the rote learning of the various national income accounting items. There was gross national product, gross national expenditure, net national income, net national disposable income … and the list went on. These measures are designed to estimate the level of and change in economic activity.

Being a sort of compliant type, I duly learned all the items by heart. It didn't occur to me until much later that national income accounting is basically claptrap.

It turns out that when economists were first considering constructing a set of national income accounts for the whole economy, there was a fierce debate about whether to include government spending in the equation. (For those who have done a bit of economics, the G in Y = C+I+G+(X-M).) Does a government spending taxpayers' money (or accumulating more government debt) really add to economic activity? Is there a case for including only the spending and income of individuals and the private sector if we are interested in fair-dinkum economic activity based on the voluntary transactions of willing buyers and sellers?

In the event, the argument for excluding government spending was lost. But treating government spending as a component of economic activity has not been a simple technical matter; it has had profound consequences for government policy. It has underpinned faith in Keynesian pump-priming as well as encouraging short-term manipulation of the figures by governments to avoid the appearance of a technical recession, which is defined as two consecutive quarters of negative gross domestic product growth.

The clearest recent case of this in Australia was the desperate efforts by the Rudd government in late 2008 to avoid a recession. It was a close-run thing, but a second quarter of negative growth was dodged by quickly ramping up government spending and handing out cash to a large chunk of the population.

The clear question now is: was it worth it? After all, there are significant measurement errors attached to the estimates of GDP. Moreover, there is precious little difference between 0.1 per cent and minus 0.1 per cent. Indeed, there is an argument that allowing the country to enter a recession could well have had a cleansing effect in terms of forcing out inefficient businesses and creating the environment for the economy to transition to activities with long-run possibilities.

New Zealand is an example of a country that endured a relatively hard landing after the global financial crisis but subsequently has done well in terms of economic growth, unemployment and fiscal outcomes.

In terms of recent GDP figures in Australia, we saw some refreshing honesty from Scott Morrison, who has admitted that the strength of the June quarter figure had a lot to do with the government's purchase of hepatitis C drugs and the delivery of a helicopter. Mind you, if we asked people in the street whether the economy seemed strong to them because of these factors, we know what the answer would be.

The reality is that the idea of GDP (or national income) is quite dangerous. It implies that policymakers can pitch for a certain growth of GDP and, in the meantime, any redistribution can be put into effect according to the preferences of the government of the day. This approach ignores the underlying micro-economics in which buyers and sellers are motivated to maximise the marginal gains from making transactions. And disturbing those incentives — through poorly designed taxes, transfers and regulations, for instance — has large efficiency downsides, something macro-economists just ignore.

This sloppy thinking is apparent when macro-economists argue for hastily put together fiscal stimulus measures. The net costs (costs minus benefits) of the spending are quickly forgotten and taxpayer money is shovelled out the door. As the Treasurer has astutely observed, "fiscal policy … at best can only ever bring forward investment rather than create it, as it eventually has to be paid for".

Does anyone believe we were better off as result of the spending on the pink batts program, including the hundreds of millions of dollars expended to rectify the original problems? The same kind of faux-purposeful thinking can be observed in the conduct of monetary policy. It is a commonly held view that the Reserve Bank of Australia was able to stave off a recession by rapidly lowering the cash rate; it was 7.5 per cent when the GFC first emerged and the rate was quickly dropped by 300 basis points.

Mind you, it's hard to interpret this decision-making as an act of genius — the direction and speed of change were pretty obvious to everyone.

What has been much more perplexing is the decision by the bank to continue to reduce the cash rate, even though it has been apparent for a long time that lowering the rate has the equivalent effect of pushing on a piece of string when it comes to business investment — a point conceded by former Reserve Bank governor Glenn Stevens. But according to the bank, a lower cash rate can induce indebted households to spend more and this may stimulate economic activity, even though savers are hurt by the lower rate. It's a numbers game for the bank: the total value of household debt is greater than the total value of savings.

Even so, Stevens recently expressed the view: "I think more of the borrowers are actually using the low rates to accelerate repayment than going to Bunnings." Quite.

You then may ask what has been the point of having such low interest rates. As one wag put it: is central banking now socialism for the wealthy, as the low interest rates push up the price of existing assets? You wouldn't be wrong in thinking that I'm not a fan of the extraordinarily low interest rates that the Reserve Bank has overseen for several years. I was particularly impressed by the open letter written recently by Hugh Giddy and Anton Tagliaferro of Investors Mutual Limited to the new Reserve Bank governor, Philip Lowe. "Lower interest rates than the current historic lows, or even the notion of negative rates, should be totally dismissed as viable policy options. There seems to be a view that fostering asset inflation creates sustainable, long-term wealth in the economy. In our view, this is certainly not the case. The extremely loose monetary policy has had the effect of redistributing wealth amongst the community to asset owners.

"What is required is saving which can fund long-term investment in productive capital. It seems that the current orthodoxy is about stimulating even greater borrowing and consumption rather than saving and investment. Interest rate policy of the RBA going forward (should) look after the interests of the savers by appropriately rewarding them."

You wouldn't also be wrong in thinking that I'm no fan of macro-economics in general. It is essentially an artefact that throws off the impression that a government or central bank can determine the level of economic activity.
Of course, fiscal prudence and low and contained inflation are important. But the main game for the government is to get the fundamentals right.

That's why structural reforms should be the main focus of policy, not the manipulation of fiscal and monetary policy to alter — at considerable cost, and unsuccessfully — the growth of GDP.