5 ½ big things Kevin Rudd doesn't understand about the Australian economy

Julie Novak &

Sinclair Davidson

August 2009

Institute of Public Affairs

Free people, free society

Five ½ big things Kevin Rudd doesn't understand about the Australian economy

1:

The current economic crisis is due to regulatory, and not market, failure

2:

The Premiers' Plan helped Australia escape depression quicker

3:

Our economic boom was much more than just mining and stockmarkets

4:

Other countries have undergone a 'building decade,' and they didn't work

5:

Greater economic self sufficiency is a recipe for lower growth

And an honourable mention:

Bureaucratic solutions are not the way to engender real jobs and growth

Introduction

On 25 July 2009 Melbourne-based newspaper *The Age* and *The Sydney Morning Herald* (SMH) published a 6,000-word essay by Prime Minister Kevin Rudd on the 'Road to Recovery.'

In many respects, the issues canvassed by Rudd were nothing new and were expressed in a style similar to that contained in his now infamous essay in *The Monthly*. Rudd views current events as a Manichaean struggle between good and evil where free markets give comfort and succour to evil men but doughty and vigilant political leadership can save society from their anti-social tendencies.

Indeed, Rudd's recent essay is reminiscent of those regularly churned out by identities of the political left and sensibly ignored by the vast majority of Australians.

What makes this essay different, however, is the author himself, who wields significant political power managing a federal budget worth almost $282 billion or 24 per cent of GDP (and spending even more than that amount).

Any errors of economic thinking on the Prime Minister's part will be felt by millions of ordinary Australians, not to mention future generations saddled with the long-term consequences of damaging economic interventions.

As *The Age* essay makes clear, Kevin Rudd's view of the economic landscape is tinged by what American economist Bryan Caplan calls the four biases:

- The 'anti-market' bias, or a tendency to underestimate the economic benefits of the market mechanism
- The 'pessimistic' bias, or a tendency to overestimate the severity of economic problems and underestimate the (recent) past, present and future performance of the economy
- The 'make-work' bias, or a tendency to underestimate the economic benefits of conserving labour
- The 'anti-foreign' bias, or a tendency to underestimate the economic benefits of interaction with foreigners (in the marketplace)[1]

Caplan is able to demonstrate how these four biases lead directly to poor policy making. In particular, they are the reason democracies choose bad policies. Rudd's essay highlights these biases and we have no doubt that they have lead to the poor economic policy choices that characterise his government.

His anti-market bias is illustrated by his description of the causes of the current economic crisis. American government policy is the direct cause of the current crisis, yet he persists in blaming some vaguely defined and never explained market failure.

His pessimistic bias is highlighted by his understanding of the Australian experience of the Great Depression, and by his understanding of more recent Australian economic history. Our prosperity is not simply due to a mining boom, but rather to a generation of hard fought bi-partisan economic reforms.

[1] Bryan Caplan, 2007, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies*, Princeton University Press, Princeton.

The notion that government can simply spend money on unproductive construction is evidence of his make-work bias. This 'solution' has a long history of failure despite being given every opportunity to succeed.

The Rudd government is ambivalent to foreign involvement in the economy. This is despite the overwhelming benefits of trade and foreign investment. To his credit Rudd is resisting some of the more anti-foreign arguments presented by some elements in the Australian community, yet he continues to promote forms of economic nationalism.

Kevin Rudd's misinformed and biased economic commentary stands in stark contrast to that used by his immediate predecessors Howard, Keating and Hawke in their public statements.

All three former Prime Ministers arguably possessed the highest degree of economic literacy of all post-war Australian leaders. This in turn was reflected through their policies, including market deregulation, public sector privatisation and freeing up the economy to grow and prosper.

It should be remembered that the current government inherited a $21 billion accrual budget surplus and a negative net debt position to help shield Australia from adverse economic shocks.

Not only does Kevin Rudd disparage the economic record of his predecessors as representing a 'neo-liberal' agenda, but his cocktail of budget deficits, public sector debt and prescriptive market regulations all stand to consign Australians to a lower growth future with higher unemployment and interest rates.

Rudd's essay reveals much about his lack of understanding about economic events and their policy implications. This paper serves to dispel some of the erroneous themes expressed in *The Age* and SMH essays, taking him to task on five (and a half!) issues raised that need to be corrected for the public record.

#1

The current economic crisis is due to regulatory, and not market, failure

Kevin Rudd has adopted a morality-play approach to the financial crisis. Yet the current financial crisis can be traced to public policy failures. These factors include a monetary policy error and the damaging consequences of 'social justice' in forming the US *Community Reinvestment Act* (CRA).

In the late 1980s social justice activists in the US alleged that banks and other financial institutions were discriminating against minorities – usually African Americans and Hispanics – in a practice known as 'redlining'. In 1989, the US Congress required banks to collect race data on mortgage applicants.

The CRA, originally passed in 1977, requires US banks to serve the entire market and not engage in redlining. In 1995, the CRA was modified directing regulators to examine how banks and financial institutions met the credit needs of the community.

Effectively banks and financial institutions were directed to lend money to sections of the community they otherwise would not lend to. The *quid pro quo* was that banks and financial institutions would be allowed to securitise the loans made under the CRA.

In 1992, the Boston Federal Reserve published a working paper, subsequently published in the prestigious peer-reviewed *American Economic Review*, which provided empirical evidence showing that banks were discriminating against minorities.[2] It subsequently transpired that the data used in the 1992 Boston Fed paper was deeply and fundamentally flawed.

The definitive study of the Boston Fed report was conducted by Theodore Day and Stan Liebowitz and was published in the 1998 *Economic Inquiry* – also a peer reviewed journal.[3] That study found that after correcting the most severe data errors that no evidence of racial discrimination could be found – banks and other financial institutions had not engaged in redlining.

The damage, however, had been done. The Boston Fed published a document in 1993 entitled 'Closing the gap: A guide to equal opportunity lending' that is still available on their website.[4] On page 13 the document states:

> 'Even the most determined lending institution will have difficulty cultivating business from minority customers if its underwriting standards contain arbitrary or unreasonable measures of creditworthiness.'

---

[2] Munnell, A., Tootell, G., Browne, L., Mceneaney, J., 1996, 'Mortgage Lending In Boston: Interpreting HMDA Data', *American Economic Review* (March): 2–54.

[3] Theodore Day and Stan J. Liebowitz, 1998, 'Mortgage Lending to Minorities: Where's The Bias?', *Economic Inquiry* (January): 1–27.

[4] http://www.bos.frb.org/commdev/commaff/closingt.pdf

The Boston Fed then discusses some of the 'arbitrary rules' that banks might apply. Considerations such as the age, location and condition of the property are 'arbitrary.' Banks are advised to review loan obligation ratios and requirements for down payments – for example, 'Policies regarding applicants with no credit history or problem credit history should be reviewed. Lack of credit history should not be seen as a negative factor.'

While the Boston Fed argues that these 'recommendations are intended as guidelines' it also sets out legal requirements for compliance in an appendix. Stan Liebowitz in a recent *New York Post* op-ed writes:

> 'Those "outdated" standards existed to limit defaults. But bank regulators *required* the loosened underwriting standards, with approval by politicians and the chattering class. … It also let community activists intervene at yearly bank reviews, shaking the banks down for large pots of money. Banks that got poor reviews were punished; some saw their merger plans frustrated; others faced direct legal challenges by the Justice Department.'[5]

In their 1998 paper, Day and Liebowitz had written, 'The currently fashionable "flexible" underwriting standards of mortgage lenders may have the unintended consequences of increasing defaults for the 'beneficiaries' of these policies.' In 2007 that prediction came true. In March 2000 the dot.com bubble deflated and the US Federal Reserve lowered interest rates. Following the terrorist attacks of 9/11 the US Federal Reserve kept interest rates low until 2004 when it started to increase interest rates in rapid incremental steps. John Taylor of Stanford University has argued that US interest rates were far below what they should have been and this caused over-investment in the housing market and over-pricing of the housing stock:

> 'During the period from 2003 to 2006 the federal funds rate was well below what experience during the previous two decades of good economic macroeconomic performance—the Great Moderation—would have predicted. … With low money market rates, housing finance was very cheap and attractive—especially variable rate mortgages with the teasers that many lenders offered. Housing starts jumped to a 25 year high by the end of 2003 and remained high until the sharp decline began in early 2006.'[6]

Ultimately, the crisis is due to government forcing banks to make loans at unreasonably low rates. Rather than have some individuals priced out of the market, government intervened and effectively lowered the price ceiling facing those individuals. This would have been less of a problem had interest rates not being artificially low after 2003. But when interest rates did fall too low, moral hazard problems arose whereby highly leveraged individuals could speculate in housing using finance from highly leveraged institutions.

The overall lesson to be learned from the current financial crisis is that public policy very often has unforeseen consequences. This is not a new lesson. However, when Kevin Rudd is unable or unwilling to heed the lessons of contemporary policy failure, this heightens the risk that harsh lessons will have to be re-learned.

---

[5] Stan Libowitz, 2008, 'The real scandal: How feds invited the mortgage mess', New York Post, http://www.nypost.com/seven/02052008/postopinion/opedcolumnists/the_real_scandal_243911.htm. An academic version of the op-ed is available; Stan Liebowitz, forthcoming, 'Anatomy of a train wreck: Causes of the mortgage meltdown', In Benjamin Powell and Randall Holcomb (eds), *Housing America: Building out of a Crisis*, Transaction Publishers.

[6] John Taylor, 2007, 'Housing and Monetary Policy', Presentation to *Symposium on Housing, Housing Finance, and Monetary Policy*, NBER Working Paper, http://www.nber.org/papers/w13682.

#2

The Premiers' Plan helped Australia escape depression quicker

Kevin Rudd stated that the policy 'alternatives were to do nothing or, worse, effectively replicate the Premiers' Plan of 1931 when governments cut expenditure, thereby compounding the problems created by a private sector already in retreat. The result, of course, was an economic rout, appalling unemployment and a decade of negligible growth through the 1930s.'

The Prime Minister's assertions do not stand up to the evidence.

In 1931, following consultation with leading economists, commonwealth and state governments agreed on a plan to restore Australia's public finances and economic competitiveness.

The plan included the reduction of all 'adjustable' government spending by 20 per cent on 1929-30 levels, including all wages, pensions and other welfare payments. It also encompassed reductions in interest rates and scope for further devaluation of the Australian dollar to reduce costs, and restore the confidence, of local industries.

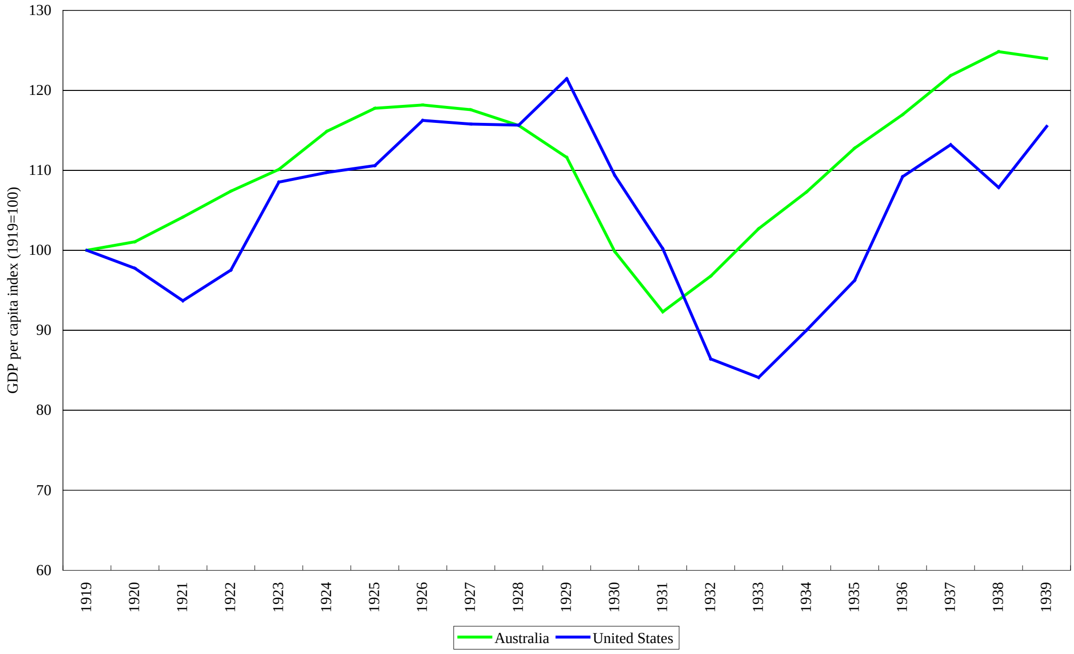
The Premiers' Plan has been reviled by many Australian economists influenced by the Keynesian tradition and also by Labor politicians. The historical record, however, is very different from the rhetorical record.

To demonstrate the point, we collected GDP per capita data from the authoritative OECD publication *The World Economy: Historical Statistics* by Angus Maddison. We convert the data into index values and plot GDP per capita over the inter-war period 1919 to 1939 for Australia and the United States.

In Australia economic growth slows and begins to decline after the return to the gold standard in 1925 – the late 1920s were hardly 'roaring' for Australia. The nadir of the Australian Great Depression occurs in 1931 – overall Australia has a V-shaped depression growth trajectory (Figure 1).

By contrast, the United States recorded a reduction in output of 13 per cent in 1932 with FDR's big-spending New Deal contributing to endemic investor uncertainty and sapping the economic growth potential of that country throughout the 1930s. This is illustrated by its long, drawn-out U-shaped depression (almost W-shaped after FDR raised taxes).

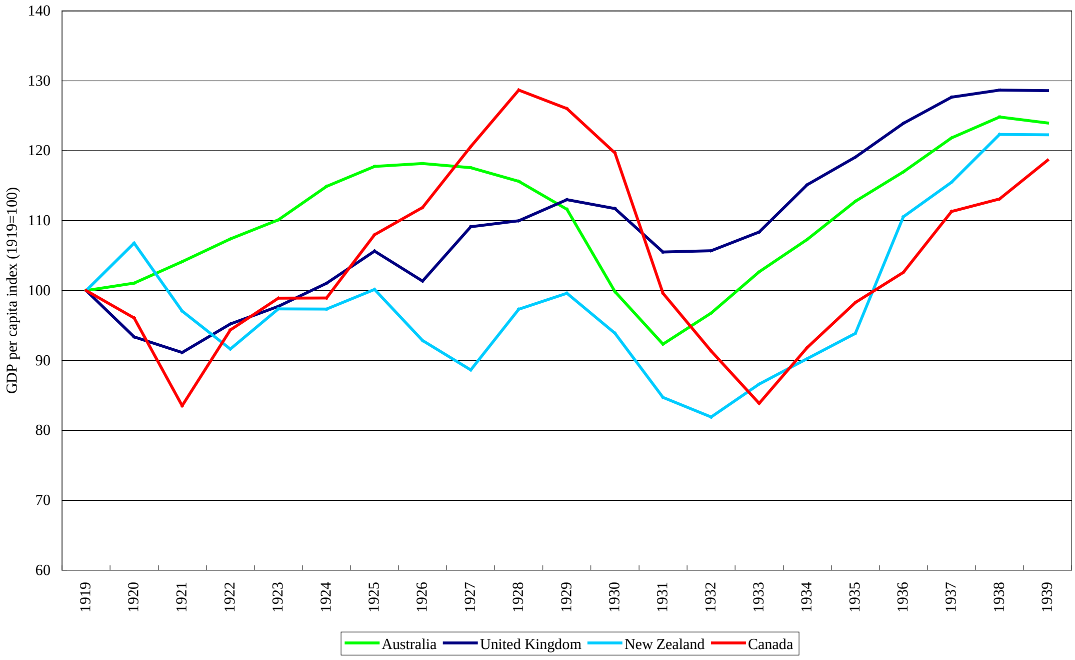
Figure 1: GDP per capita, Australia and United States; 1919 to 1939



Source: OECD The World Economy: Historical Statistics, Angus Maddison.

Two policy events occurred in 1931: the Premiers' Plan was adopted and Australia excised its gold standard. Many economists argue that it was the latter that led to the recovery. To test that view we also look at GDP per capita for Canada, New Zealand and the United Kingdom – all members of the former British empire (Figure 2).

Figure 2: GDP per capita; Australia, Canada, New Zealand and United Kingdom; 1919 to 1939



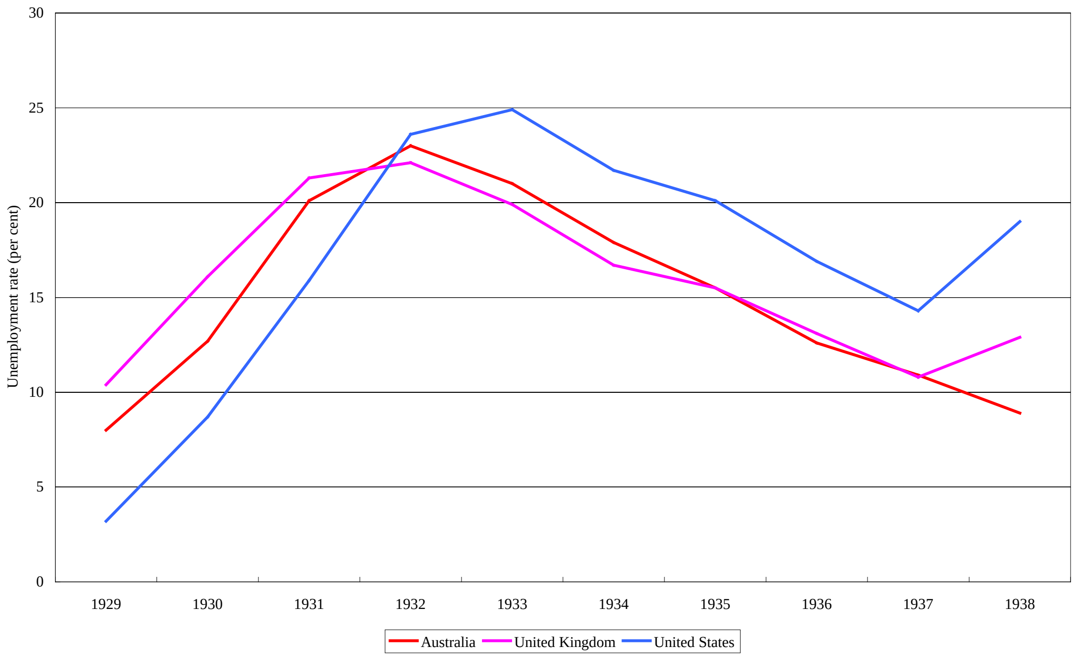
Source: OECD The World Economy: Historical Statistics, Angus Maddison.

It is quite clear that Australia's economic recovery begins before the other countries. Clearly leaving the gold standard was an important component of recovery, however there is no evidence supporting Rudd's interpretation that adoption of the Premiers' Plan lead to an economic rout. To the contrary, the Australian economy made a significant recovery by international standards.

The unemployment data over the era shows a slow recovery from the depths of the depression. The argument that employment growth was slow in the 1930s is consistent with the notion of 'jobless recoveries.' This phenomenon is hardly unique to that period.

The important thing to notice is that unemployment in Australia falls steadily over the decade after the early 1930s, outperforming the capacity of the New Deal US economy to absorb labour.

Figure 3: Unemployment rate; Australia, United Kingdom and United States; 1919 to 1939



Source: OECD The World Economy: Historical Statistics, Angus Maddison.

The success of Australia's Premiers' Plan did not go unnoticed at the time. Even Rudd's economic hero – John Maynard Keynes – was inspired to write in the Melbourne *Herald* in June 1932 that the Plan 'saved the economic structure of Australia.'

#3

Our economic boom was much more than just mining and stockmarkets

Kevin Rudd claimed that 'in the past, Australia relied almost exclusively on the rollercoaster of the boom and bust of the mining sector or the stockmarket.'

A cursory examination of ABS national accounts data shows that an increase in gross value-added (a measure of output) was recorded for each major industry, not just mining or financial services, since the trough of the previous business cycle in late 1991 (Table 1).

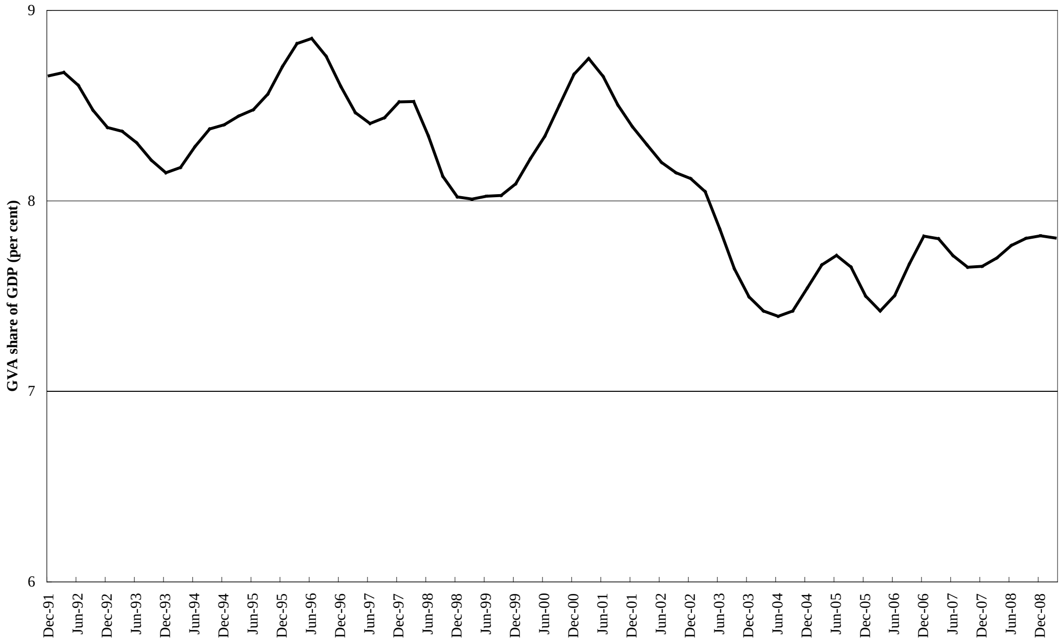
Table 1: Industry gross value-added; chain volume measure

	December 1991	March 1996	December 2007	December 2008	March 2009
Agriculture	4,405	5,143	6,180	7,181	7,525
Mining	13,045	15,721	20,699	21,358	21,315
Manufacturing	19,636	21,948	26,528	25,715	24,871
Electricity gas water	4,533	4,943	5,450	5,664	5,717
Construction	8,068	9,657	19,088	19,847	19,687
Wholesale trade	6,245	8,132	12,196	12,155	11,888
Retail trade	7,961	9,194	14,730	14,876	14,973
Accommodation cafes restaurants	2,865	3,314	5,164	5,047	5,050
Transport storage	6,457	7,869	12,635	12,792	12,597
Communication services	2,007	3,055	6,593	6,592	6,570
Finance insurance	9,880	11,593	20,471	20,405	20,454
Property business services	14,989	18,670	32,376	32,763	31,846
Education	7,864	8,825	10,900	11,060	11,098
Health community services	8,602	10,180	15,667	16,133	16,290
Cultural recreational services	2,276	2,505	4,008	4,126	4,079
Personal other services	2,862	3,309	4,930	5,056	5,063

Excluding government administration and defence.
Source: ABS, Australian National Accounts: National Income, Expenditure and Product, cat. no. 5206.0.

The mining industry's gross value-added as a share of national GDP has trended downwards since the 1990-91 recession and, more recently, since the turn of this century (Figure 4).

Figure 4: Mining industry gross value-added as a share of GDP; chain volume measure

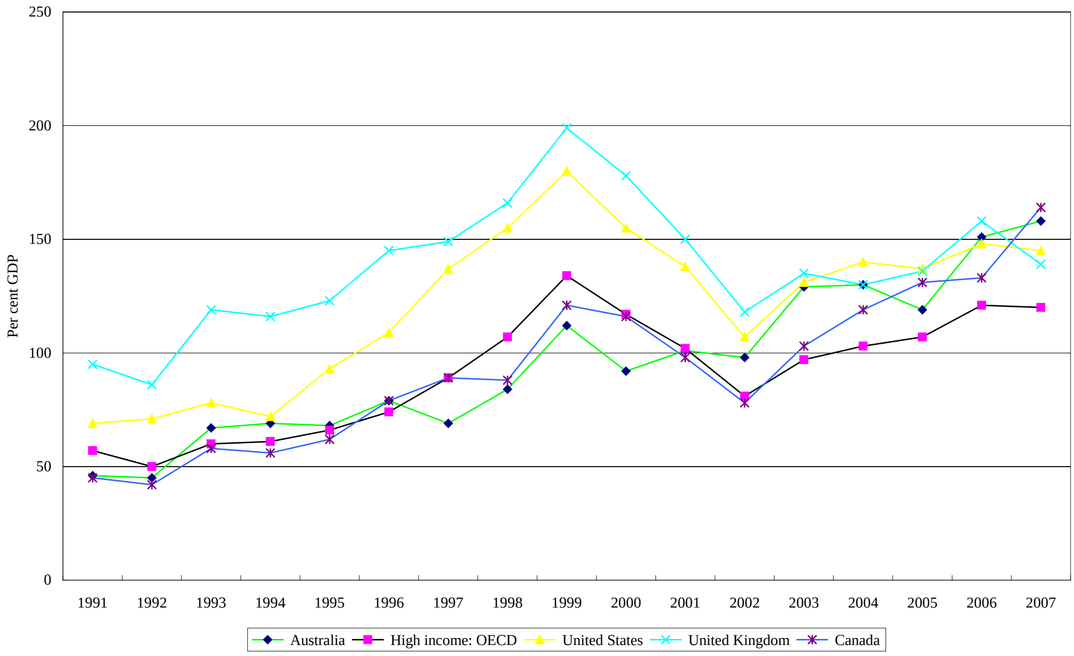


Source: ABS, Australian National Accounts: National Income, Expenditure and Product, cat. no. 5206.0.

Similarly Rudd's argument that Australia relied on a rollercoaster stockmarket is unsupported by the evidence. Stock market values have increased dramatically in recent years (prior to the crisis), yet so too did the economy. The ratio of stock market capitalisation to GDP for Australia has grown in line with that of the OECD as a whole and with comparable economies (Figure 5).

Immediately prior to the crisis the ratio for Australia was similar to that of the UK and US; Australia has not been as affected by the crisis as those two countries. Consequently it is difficult to argue that a stock market boom is the cause of the crisis.

Figure 5: Market capitalisation; per cent of GDP



Source: World Bank Development Indicators.

#4

Other countries have undergone a 'building decade,' and they didn't work

In his essay, Kevin Rudd recommends that 'Australia must embark upon a Building Decade, implementing a plan of nation-building for the future.'

Attempts by other nations to embark on a 'building decade' of public infrastructure have been made, and they have failed at every turn.

Between 1992 and 2000, Japan implemented almost a dozen separate stimulus packages emphasising public infrastructure investment. As explained by economic historian Amity Shlaes, 'the spending yielded painfully little for the rest of the economy. The Nikkei stayed down. The country's standard of living failed to keep pace with the rest of the world's.'[7]

Shlaes also noted that the Japanese unemployment rate had doubled during the infrastructure boom decade of the 1990s. At the same time as failing to revive the economy, Japan incurred a substantial public sector debt of a size in excess of its total economy.

The case of the remote western Japanese port of Hamada is instructive. Almost two decades of government capital works included a 'hakomono' (or white elephant) bridge, highway, two-lane bypass, university, prison, children's art museum, sports centre, a 'welcome' centre, ski resort and an aquarium featuring three Beluga whales.[8]

According to a Japanese economist, Toshihiro Ihori, 'it is not enough just to hire workers to dig holes and then fill them in again. ... public works get the best results when they create something useful for the future.' His economic analysis suggested that the Japanese building decade crowded out valuable private sector investment thus dragging back overall growth in that country.

The Depression-era United States also engaged in a massive capital expenditure program, including the construction of dams throughout the Tennessee Valley, yet low growth and high unemployment persisted during the 1930s.

Less than six per cent of the Rudd government's $42 billion stimulus package in February 2009 was directed to road and rail projects. Other spending was directed to overpriced school halls and toilet blocks, housing insulation batts, a range of local government boondoggles (such as public iPod docking stations, reshaped creek banks, sheds and eucalypt museums) and plaques designed to 'boost confidence.'[9]

---

[7] Amity Shlaes, 2008, 'The Perils of a Cement Tsunami', The Washington Post, 10 December.
[8] Martin Fackler, 2009, 'Japan's Big-Works Stimulus Is Lesson', The New York Times, 5 February.
[9] ABC Insiders, 2009, 'Mark Arbib discusses stimulus spending', 5 July, http://www.abc.net.au/insiders/content/2009/s2617057.htm.

A cursory examination of the federal government's stimulus website shows that there are many Hamada works being developed in our own back yard.[10] Similar to the case of the Japanese port town, it is highly unlikely that our domestic spending escapades, undertaken at taxpayers' expenses, will yield a flow of economic returns sufficient to cover the initial funding.

Until the government provides detailed, independently verifiable evidence that the economic and social benefits of current infrastructure projects exceed their costs, community hesitation to give Kevin Rudd a green light on a 'building decade' is well justified.

[10] See http://www.economicstimulusplan.gov.au/pages/default.aspx.

#5

Greater economic self-sufficiency is a recipe for lower growth

Kevin Rudd maintains an ambivalent position when it comes to matters of international trade and investment.

To his credit, Rudd is currently resisting the anti-foreign biases of the self-interested trade union movement on a number of fronts. However, Rudd did stoke their autarkic ambitions by asking in his first speech as Opposition leader in late 2006 'Will we still make things? Or is that all gone?' and declaring prior to the last election that he wanted Australia to be 'a country that actually makes things.'

The Rudd government has also not been as welcoming of foreign investment, especially from China, as we might have hoped.

Rudd's essay contains passages that portray cross-border market exchanges in a negative light:

- 'if we succeed, we will have built in the decade ahead an Australian economy on rock-solid foundations for the future, rather than one that rests primarily on the shifting sands of international fortune'
- 'the government has embarked on long-term economic reform … rather than cyclical windfalls from mining booms entirely captive to global factors beyond our national control.'

Australia has experienced a secular increase in exports, including in manufactured products, over the past two decades (Table 2). Even despite the slowdown experienced during the March quarter 2009 export values were still double those at the trough of the last growth cycle.

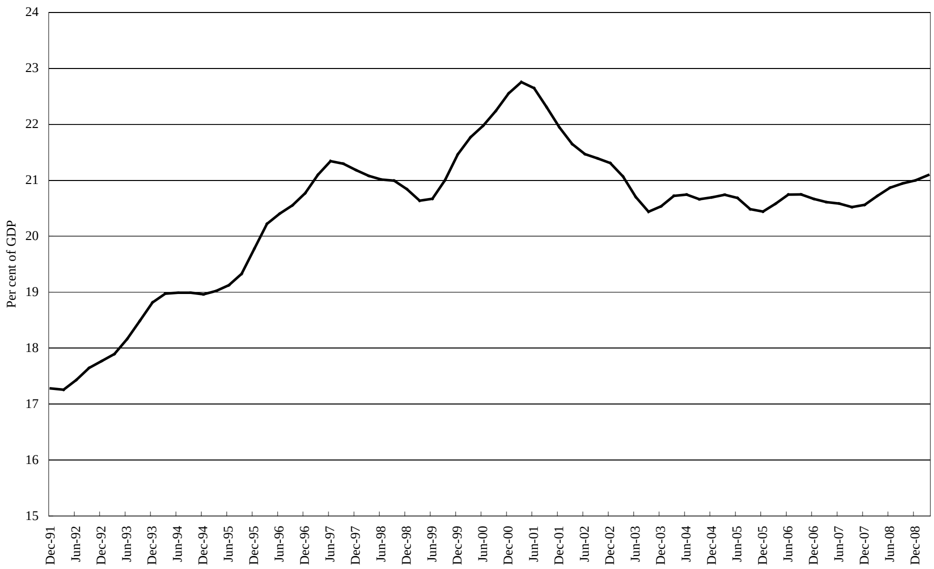
Table 2: Value of selected merchandise exports; chain volume measure

	December 1991	March 1996	December 2007	December 2008	March 2009
Rural goods	4,772	5,208	5,769	6,058	6,661
Metal ores	4,752	5,346	10,328	10,138	9,644
Other metals	2,773	3,347	3,915	4,372	4,059
Machinery	661	1,337	2,275	2,315	1,860
Transport equipment	425	668	1,611	1,576	828
Other manufactures	1,344	1,975	4,288	4,311	3,673
Other non-rural goods	867	998	3,384	2,735	2,609
Total goods credits	21,793	26,926	44,501	45,505	42,653

Source: ABS, Balance of Payments and International Investment Position, Australia, cat. no. 5302.0; original series.

The export share of total national output has also increased since the early 1990s (Figure 6). Despite Rudd's uneasiness Australia is still very much a country that makes things, so much so that it is selling its wares around the world.

Figure 6: Exports of goods and services as share of GDP; chain volume measures



Source: ABS, Australian National Accounts: National Income, Expenditure and Product, cat. no. 5206.0; trend.

If exports stayed at their December quarter 1991 level Australia would have lost about four per cent of GDP or roughly almost $470 for each man, woman and child (March quarter 2009 figures). This underlines the undeniable fact that exposure to international markets (in other words, less economic self-sufficiency) has delivered economic gains to Australia.

It is true that the absorption of inputs has increased as well. Despite recent protestations from the trade union movement, this trend is not problematic and has proven to be beneficial for businesses and consumers alike. The reduction of tariff and other trade barriers by Australia has enabled firms to benefit from the reduced costs of imported capital items and other intermediate goods. Further, the inflow of cheap imported consumer goods satisfies the economic needs of consumers at home, contributing to our historical low inflation of recent years.

Australia's progressively open economic relationship with the world extends to capital flows, with an inflow of capital from investor interests abroad representing a key driver of our long term economic development.

As the IPA submission to the current Senate inquiry into foreign investment by state-owned entities testified, consideration needs to be given to relaxing Australia's FDI policy to attract more investment in a capital-constrained world.[11] The economic literature has conclusively demonstrated that there exists a positive relationship between trade and investment openness and economic growth.[12] This is why it is in Australia's best interests to keep our economic doors open to the world, and not decry the consequences of this policy stance as does our current Prime Minister.

[11] Sinclair Davidson, Julie Novak and Tim Wilson, 2009, Submission to the Senate inquiry into investment by State-owned entities, http://www.aph.gov.au/senate/committee/economics_ctte/firb_09/submissions/sub32.pdf.
[12] Joshua A. Byrge and Michael R. Pakko, 2006, 'Freedom, Trade and Growth', International Economic Trends, Federal Reserve Bank of St. Louis, http://research.stlouisfed.org/publications/iet/20061101/cover.pdf.

And an honourable mention:

Bureaucratic solutions are not the way to engender real jobs and growth

The Rudd essay is replete with assertions that actions by governments, including through the unaccountable G20 international bureaucracy, are necessary to rescue economies and put them back on a sustained growth path.

As Kevin Rudd himself put it, 'as the crisis took hold, responsible governments around the world were forced the step in to stabilise fractured financial markets and to support growth and jobs through unprecedented fiscal stimulus.'

Rudd is using Keynesian-style arguments to support an agenda expanding the size of government. According to the Treasury budget papers, federal general government payments as a share of the economy have jumped from 24 per cent in 2007-08 to almost 29 per cent expected in this financial year – a massive twenty per cent jump in the amount of federal spending in a short period of time.[13]

Treasury figures also show that state and local governments are getting in on the act of spending like there's no tomorrow.

While using policy justifications from the post-war Keynesian copybook, it is arguable that Rudd is going down a path that not even John Maynard Keynes would have supported. After all, Keynes once said that economic performance would be hampered if tax and spending exceeded 25 per cent of GDP.[14]

Since Keynes' time, the empirical literature has conclusively demonstrated a significant and negative relationship between the size of government and economic activity in the long run.[15]

There is no magic pudding or free lunch when it comes to economic management. Government cannot stimulate an economy without first extracting funds, in the form of taxation or borrowings, from economic agents.

This explains why governments are also not the job-creation machines that Kevin Rudd thinks they are.

Governments are hoping that the 'seen' outcomes of its spending spike, such as the hastily laid construction sites and the feel-good photo opportunities, will lead to tangible growth. But it is more likely that the 'unseen' misallocation of resources and destruction of

---

[13] Commonwealth of Australia, 2009, *Budget Strategy and Outlook 2009-10*, Budget Paper No. 1, Canberra.
[14] Quoted in Vito Tanzi and Ludger Schuknecht, 2000, *Public Spending in the 20th Century: A Global Perspective*, Cambridge University Press, Cambridge.
[15] Tanzi and Schuknecht, Ibid; Daniel J. Mitchell, 2005, 'The Impact of Government Spending on Economic Growth', Heritage Foundation Backgrounder no. 1831; Dennis C. Mueller, 2003, *Public Choice III*, Cambridge University Press, Cambridge.

economic value from wasteful expenditure will render harm to current and future generations.

The latest Kevin Rudd essay once again illustrates the Prime Minister's lack of understanding of why economies have come unstuck, as they have done in recent months, and what sort of policy strategies are required to get markets investing, producing and employing again.

Ideas do indeed have consequences. Until such time that the Prime Minister gets the intellectual basics right on the economy, average Australians are likely to continue feeling the pain of the government's economic mismanagement.