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PAST ISSUES

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Econometrics of the financial crisis – Just another dummy variable?

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Motu Economic and Public Policy Research

Infrastructure Research at Motu

Greater investment in infrastructure was a feature of the electoral campaigns for both major parties in New Zealand's recent election. At Motu Economic and Public Policy Research, we are two years into a four-year infrastructure research programme funded by the Foundation for Research, Science and Technology. This report provides a brief summary of the programme.

Motu's infrastructure work is essentially a series of evaluations of major infrastructure investments. It examines the impacts of infrastructure on productivity and other measures, focussing on transport (roads, rail, ports, airports), water (irrigation), broadband, and social infrastructure. The goal is to provide rigorous analyses to support private and public sector decision-making agencies in directing infrastructure investments to areas that have the highest potential payoffs for New Zealanders.

Some analyses within the programme employ a revealed preference methodology in which changes in land values are used as a proxy to reveal the value of improvements in services and amenities. This technique has the advantage that the researcher does not need to isolate or quantify all sources of potential benefit from a new investment. It is common in evaluating infrastructure benefits in the United Kingdom and the United States (e.g. to evaluate benefits of Crossrail in London and to evaluate extensions to Chicago's rapid transit system).

Three working papers are now available from Motu. These look at the effects of Auckland's Metropolitan Urban Limit, Auckland's Northern Motorway extensions and of irrigation in the Mackenzie District (Canterbury). We have also completed some research comparing public transport services across major Australasian cities.

The research team for this project includes Arthur Grimes, David Maré, Andrew Coleman and Steven Stillman from Motu, Philip McCann and Jacques Poot from the University of Waikato, with links also to Victoria University of Wellington's School of Government. Three graduate students at the University of Waikato are funded to work on aspects of the research.

Current and future research topics include: the impact of broadband on New Zealand firm outcomes, considerations around infrastructure location for time-sensitive services (including emergency services), the impact of ports and airports on exporters' location and performance, the effects of transport infrastructure on Auckland firms' productivity, links between infrastructure changes and the shape, size and nature of labour market areas, impacts of social infrastructure investments within cities, and impacts of Auckland's passenger rail upgrades.

Further information and publications are available at: **www.motu.org.nz/infrastructure**. **[]**

EDITORIAL

False confidence?

Stuart Birks (k.s.birks@massey.ac.nz)

In response to the conference coverage in the last issue of *Asymmetric Information*, David Hendry sent me a chapter he has written for a book due out next year. In it he spells out many concerns about and problems with applied econometrics. Hence, "To believe that he or she had ascertained the 'truth', an applied econometrician would have to believe at least the following dozen impossible (composite) assumptions". It is well worth a read. I was reminded of E J Mishan's seven conditions required to ensure a positive relationship between growth and social welfare (Mishan, 1967, pp.219-220). In these and other instances, our analyses and conclusions are subject to serious reservations, but they receive tacit acceptance nevertheless.

We are all familiar Friedman's assertion, "Truly important and significant hypotheses will be found to have 'assumptions' that are wildly inaccurate descriptive representations of reality..." (Friedman, 1953, p.14). Perhaps this has led us to be blasé about our assumptions. Alternatively, we may have been willing simply to follow the accepted conventions as we do not have available alternatives.

The dangers of this approach are highlighted when we see alternative conditions that can result in the same findings, but we often stop at the point where the findings are considered consistent with our hypothesis. Note another caution by Friedman, "If there is one hypothesis that is consistent with the available evidence, there are always an infinite number that are" (p.9). We can be drawing conclusions on the basis of our theories and analyses of available evidence when our reasoning may be flawed, or, at least, when the evidence is consistent with numerous alternative interpretations.

There is a book by Mishan, published in 1969, in which he described 21 economic fallacies. He described policies that were introduced for which there had not been "broadly based and informed debate on their economic and social consequences" (p.9). Next year will see another book in his name, *Thirteen Persistent Economic Fallacies*. One interpretation of these books, perhaps the intended one, would be that people have, and are possibly acting on, false perceptions of economic phenomena. In this case we are wrong to assume logical interpretation of the evidence. An alternative interpretation could be that economic reasoning, being based on a simplified view of the world, may give conclusions that are at odds with those of individuals who have a more nuanced view. More likely, though, would be one of the other myriad of hypotheses consistent with the information, including those which assume poor understanding by all concerned.

In summary, unrealistic assumptions may be giving us a false confidence in questionable findings. We may be too willing to accept conclusions based on dubious methods, rather than looking for alternative conclusions that are consistent with the evidence.

Members are invited to submit brief articles on any issue of interest to NZAE members, and/or comments and suggestions. Enquiries and contributed articles should be sent to Stuart Birks [K.S.Birks@massey.ac.nz].

Views and opinions expressed in these articles are those of the authors, and do not represent the views of the New Zealand Association of Economists

Friedman, M. (1953). *Essays in positive economics*. Chicago, Ill.: University of Chicago Press

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Mishan, E. J. (1967). *The costs of economic growth*. London: Staples P.

Mishan, E. J. (1969). *Twenty-one popular economic fallacies*. London: Allen Lane.

Mishan, E. J. (forthcoming 2009). *Thirteen Persistent Economic Fallacies*. Portsmouth, NH: Praeger Publishers **[]**

More on the 2008 Conference

In addition to the coverage in the extra-large August issue of Asymmetric Information, here are two more pieces on this year's conference

Robert J. Gordon: "The History of the Phillips Curve: An American Perspective"

(by Brian Silverstone)

The Phillips-ESAM 2008 Symposium began splendidly with Robert Gordon's Keynote Address on the history of the Phillips curve from an American perspective. His paper will be required reading for some time to come. It is in the spirit of Olivier Blanchard's (2000) view that there are two steps to studying macroeconomics: 'First, to see it as it is today. Secondly, to understand how it got there, to understand the right and wrong turns, the hypotheses that proved false, the insights that proved true and the interaction of events and ideas'.

Professor Gordon has no doubts about the right and wrong turns, the hypotheses that proved false, the insights that proved true and the interaction of events and ideas. His overall theme is that Phillips curve research 'split down two forks' after 1975 with little communication or interaction between them. The distinction is very important. One fork, the mainstream Keynesian (KPC) approach, is dominated by three components: long lags on past inflation (that is, persistence and inertia), demand shocks and supply shocks. The other fork, centred on the New Keynesian Phillips Curve (NKPC) approach, is dominated by two components: current and forward-looking (policy-dependent) expectations and demand shocks. Inertia and explicit supply shocks are absent from NKPC models.

Robert Gordon takes us, first, through the changing interpretations of the Phillips curve between 1958 and 1975. Some interesting reminders emerge from his analysis of this period including the observations that Phillips (1958) does not mention policy implications at all, that Fisher (1926) ran the direction of causation from the rate of inflation to unemployment and that both the policy ineffectiveness proposition - that anticipated monetary policy cannot have real effects - and attempts to deny a long-run trade-off between inflation and unemployment were empirical failures.

Professor Gordon selects 1975 as a 'clear break' in the history of the Phillips curve for two reasons. First, the policy ineffectiveness proposition was published in 1975 and, in the same year, the United States experienced the maximum impact of supply shocks. On the latter theme, Gordon himself contributed significantly to the theoretical inclusion and empirical validity of supply shocks into Phillips curve analysis. He also produced one of the earliest papers dealing with the 'false assumption that the natural rate of unemployment was fixed'. These are impressive contributions.

In the final sections of his paper, Robert Gordon considers the 'second fork' in the history of the post-1975 Phillips curve. The themes he covers include policy games in the context of time-inconsistency and the New Keynesian Phillips curve.

These themes are followed by Gordon's own work specifying and estimating models to test the validity of the 'mainstream/triangle' Keynesian and New Keynesian Phillips curve models to explain the American inflation-unemployment experience between 1962 and 2007.

As a result of both his empirical work and historical survey, Robert Gordon leaves us in no doubt how he sees the Phillips curve today. The New Keynesian Phillips curve (NKPC) can be nested within the 'triangle econometric specification' of the post-1975 Phillips curve, namely, inertia, demand and supply. Unless a country is facing rapid inflation and monetary instability, 'the triangle model outperforms the new NKPC by orders of magnitude, not only in standard goodness of fit statistics, but also in post-sample dynamic simulations'.

Finally, Robert Gordon's history of the Phillips curve takes an American perspective partly because 'the authors who have made the most impact on the PC literature have been American'. Despite an already-lengthy paper, there might have been a case for a few more references to both non-American contributions and to other major survey articles. This point aside, Professor Gordon, in both his Keynote Address and his paper itself, has contributed significantly to his ultimate aim of starting a reconciliation in post-1975 Phillips curve research.

I had the honour of meeting Bill Phillips on several occasions in the early 1970s. In one of our conversations, Bill told me that he had not done very much: 'All I did was put out a few hares for people to chase'. Fifty years on from Bill's classic contributions to macroeconomics, the hares - as Robert Gordon has shown - are still being chased with undiminished vigour.

Readers of *Asymmetric Information* might also be interested in the Emmanuel De Veirman and Tim Ng interview with Robert Gordon entitled 'Events Precede Ideas: Bob Gordon on Macroeconomics and Monetary Policy' in the Reserve Bank of New Zealand *Bulletin* 71(3) September 2008. **[]**

Lines in Law (and elsewhere)

by Stuart Birks (k.s.birks@massey.ac.nz)

Lines in law received a mention in **Joel Slemrod's** conference presentation. He highlights something that may be a common problem. Legal or tax treatment can depend on the side of a line someone lies. For example, tax rates can change from one year to another, and a few days' difference in the receipt of income, if crossing this line, can therefore alter the tax liability. There is a difference in tax treatment of capital gains from investing in property compared with dealing in property. Intent, or motive, may be significant in treatment, as also with murder versus manslaughter. We should note also the treatment of disability differs according to whether it is due to illness, or to accident, thereby coming under ACC. Structures displaying such discontinuities are unlikely to be optimal, although they may involve lower administrative or enforcement costs than more nuanced approaches. People who are used to marginal analysis may be uncomfortable with such lines[1], but examples can be found in economics and econometrics also.

In economics, consider the definition of recession, when real GDP declines for two consecutive quarters. This is the net effect of numerous increases and numerous declines in the figures that, in aggregate, constitute GDP. Great significance is placed on whether the net effect is slightly above or slightly below zero, and the psychological (and possibly political) importance is far greater than really warranted from such a knife-edge difference. In other words, there is a rhetorical, rather than a logical, interpretation of these results (and yet we persist in assuming that people are rational).

Consider also significance in econometrics. Great weight may be placed on whether a coefficient has a t-statistic just above or below some specified level. If above the level, the coefficient is commonly treated as if its true value is *exactly as estimated*. If below the level, the coefficient is treated as if its true value is *zero*. Confidence intervals in the two cases could be almost identical, roughly zero at one end and twice the estimate at the other.

Where a small difference in a result can have a marked effect on interpretation, our conclusions can be very sensitive to the formulation of the problem. Take two variables that are included in a multiple regression equation. Let's call them X_1 and X_2. Imagine b_1 just significant, b_2 not quite significant, at some specified level.[2] In addition, assume that both are of roughly equal value.

Now consider the question whether b_1 is significantly different from b_2. Instead of an equation containing $b_1X_1 + b_2X_2$, as used for the above finding, the equation could be rewritten to contain $b_1(X_1 + X_2) + b_3X_2$ (so $b_2 = b_1 + b_3$, and the test is whether b_3 is significantly different from zero).

The two formulations have not changed the underlying relationships, but there could be a large change in the apparent results. With the former, it could be determined that X_2 has no significant (marginal) impact on the dependent variable and can be ignored. In contrast, the latter may well yield results that would be interpreted as both X_1 and X_2 being significant, with there being no significant difference in their coefficients. **[]**

A piece of history, and a forecast (logic or rhetoric?)

From the *Taranaki Herald*, Volume LIV, Issue 13657, 13 May 1908, Page 5 on **http://paperspast.natlib.govt.nz/**

AMERICAN REPUBLICS.
SEEKING CLOSER RELATIONS.
A UNITED STATES MOVEMENT.

By Electric Telegraph.— Copyright. NEW YORK, May 12.

President Roosevelt laid at Washington the corner stone of the building intended to house the Bureau of American Republics. There was a vast assemblage, including representatives of all branches of the national and State governments. President Roosevelt; Mr Elihu Root; and Mr Andrew Carnegie spoke. Communications were received from all the presidents of the American republics. The building costs a million dollars. Mr Carnegie contributed -three-fourths of the sum.

President Roosevelt remarked that although during the last century development had proceeded faster in North America than in South, he believed that during the present century no part of the world would see such an extraordinary development in wealth and population and progress as Mexico, and Central South America. The, people of the United States, he said, regarded with profound satisfaction the great growth that had already taken place there in political stability and material well-being. Mr Elihu Root's recent tour showed that the citizens of the United States recognised that their interests were more closely intertwined with those of other republics of the American Continent than with those of other nations. **[]**

1 There may be occasions where lines are warranted, as with 'tipping points', or rising water levels for a non-swimmer, but then the actual position of the line is also crucial.

2 As Allan Rae would say, actually all variables are significant, it is just a matter of what level

Government Guarantees for Private Banks: or "Everybody's doing it, why not New Zealand?"

By Bryce Wilkinson (brycew@capecs.com) and David Tripe (D.W.Tripe@massey.ac.nz)

> Helen Clark grabbed the political limelight at her campaign opening by pledging a Govt guarantee for retail bank deposits. Subsequently it became clear that this had been forced on the Govt by Aust's decision to move immediately on a guarantee for bank deposits.
>
> *trans*Tasman, 23 October 2008.

An announcement that grabs the political limelight does not necessarily make the economic boat go faster. So is it plausible that the benefits to the community from this measure exceed the costs?

Usually such assessments are required to take the form of a regulatory impact statement. This statement must, *inter alia*, identify the actual problem as distinct from the symptoms and make a plausible case that the net benefits of the preferred course of action are positive and greater than those offered by the next best alternative.

Treasury advises that no supportive regulatory impact statement was produced for this measure. This is because, under the Public Finance Act, the Minister of Finance has the delegated authority to take such extraordinary measures without this safeguard.

The Act embodies the safeguard of requiring the Minister to report to parliament as soon as is practicable. But a government in the middle of a general election could put tens of billions of dollars of taxpayers' money at risk, perhaps effectively irreversibly, without having to account to anybody but poorly-informed public opinion during an election campaign. Alternatively, it could take a sound decision in the national interest and get lambasted for it because of public ignorance of the circumstances.

Another safeguard is the convention that a government will not make major decisions on its own bat prior to a general election, for obvious reasons. As the Public Finance Act permits, exceptions have to be made for emergencies, but here the principle should be that decisions should be non-partisan if possible.

In the absence of a supporting regulatory impact analysis, how do those who took the decision know that it was sound? The purpose of this article is to make a preliminary contribution to an economic assessment of the case for guaranteeing NZ bank deposits at the moment of that decision.

The article focuses on two questions – was immediate action necessary in an essential public interest and, if immediate action was not necessary, was it nonetheless desirable? For reasons of space, this article does not address the wholesale deposit guarantee issue.

This was clearly a rushed decision. Following the announcement on a Sunday, officials clearly had to scramble to devise a scheme that was as workable as possible. The subsequent amendments and modifications have made it obvious that important aspects of the policy were being developed 'on the hoof'. However, evidence of a rushed decision is not proof of a forced hand.

So did the Australian government decision really 'force' the New Zealand government's hand in that weekend? Clearly, the New Zealand government did not consider that its hand was forced in respect of a guarantee for the overseas lending lines of its private banks. (New Zealand did not immediately follow Australia in that respect.)

So what was the case that New Zealand's hand was forced in respect of retail deposits at private banks? In public at least, the case seems to be, in essence, that there would have been a 'giant sucking sound' as funds flew out of New Zealand to seek the security of Australian-government-guaranteed deposits with Australian banks.

The following four points suggest that this assertion does not constitute a plausible case for urgent action.

First, there seemed to be a consensus amongst banking experts that New Zealand banks as a whole are sound (solvent). None have incurred losses of any significance in relation to their capacity to absorb losses. Nor are we aware of any factual evidence that New Zealanders were trying to switch deposits to Australian banks to any major degree. So any concerns were surely about a future problem that might arise rather than a demonstrable existing problem.

Second, nervous depositors who want a government-guaranteed investment could achieve their goal independently of the Australian announcement. Apart from the many other countries that offer government protection for bank deposits there is also the world market for government bonds. Those who want New Zealand dollar investments that are essentially free of default risk can purchase New Zealand government stock, Treasury Bills, Kiwi Bonds, or the paper of 100 percent government-owned or controlled organisations such as Kiwibank or the Public Trust, and it was our understanding that there was some movement of funds to these alternative channels. Kiwibank offers tax-advantaged PIE schemes. For many depositors the option of an Australian currency deposit in an Australian bank would be not be preferred on the grounds of inconvenience, currency risk, transaction costs, and tax. There is no general clearing system in New Zealand for settlement of transactions in Australian dollars.

Third, the balancing consideration for risk is price. Bank deposit interest rates must always be priced against the risk-free rate. Private banks have always had to pay whatever margin above the risk-free rate is necessary in order to attract deposits. At times of extreme risk aversion, they simply have to pay more (as do the risky borrowers they lend to). A related aspect of this is that if the Australian government charges Australian

banks fully for the cost of the guarantee, they should not have a material competitive advantage compared to unguaranteed New Zealand banks. The case for a New Zealand guarantee would stop right there. Alternatively, if the Australians under-price their guarantee for banks, for New Zealand to do the same would be to favour the guaranteed domestic institutions relative to the unguaranteed capital markets such as the corporate bond market and the market for institutional funds. Arguably the optimal policy for New Zealand would be to avoid that distortion. New Zealand banks already have to compete with government-guaranteed investments domestically and worldwide. The expansion of the domain for such investments in Australia is not a fundamental change to that reality.

Fourth, at the macro level the fallacy of composition applies. As long as New Zealand is running a current account deficit in its balance of payments, it must be experiencing a net capital inflow. A sudden massive *net* capital outflow is impossible as everyone who wants to sell New Zealand dollars must find a buyer. It follows that a panicky net private capital outflow cannot occur unless government agencies are net buyers of New Zealand dollars. In short, fears of an actual sudden disruptive net capital outflow are unfounded under a floating exchange rate regime (shocks are experienced instead as exchange rate volatility).

In conclusion, if a plausible economic case was made during that weekend for *immediate* action it would be good to know what it was.

We now turn to the second question of whether the benefits of the proposed scheme plausibly exceed the costs.

A Walrasian neoclassical general equilibrium economist might observe that as long as any government guarantee is priced correctly people will be indifferent at the margin between a risk-free opportunity and a risky opportunity. Assuming take-up, investors will now be indifferent as to whether they invest in government bonds or government-guaranteed finance company or building society deposits. Also by assumption, lenders will face the correct price of capital – the risk-free rate plus the insurance premium.

The key error here is the assumption that a government guarantee can be priced correctly, in the absence of a market for assessing and pricing exactly those risks. Instead of market discovery of the price of risk, politicians could determine, directly or indirectly, the charges for the taxpayer guarantees. Certainly they will be advised by experts. But experts are fallible. They have incomplete information are likely to differ, and are probably not putting their own money on the line - or may be compromised if they are. As those charged with estimating bank capital requirements under the Basel II rules have found, it is very difficult to estimate reliably losses for very rare events. Cross-country data is questionable because of differences in the structure and regulation of banking systems. Lack of information makes judgments somewhat arbitrary. Arbitrary decisions easily give rise to the familiar public choice theory problems of incentives and lack of information.

A related problem is that any fee that is right initially could soon be wrong. This is because of the authorities are likely to fail to accurately perceive changes in the market price of risk for the institution concerned.

For these reasons, any levels for the guarantee fees for retail deposits in New Zealand are likely to be problematic (but better than no fee). Although the fee for the wholesale funding guarantee is higher, we suspect that its level has been set on the basis of the level set in Australia (noting that banks have some flexibility as to which country's guarantee they should utilise), rather than relative to a market-determined fee level such as in the United Kingdom.

From a capital market and prudential perspective, a fundamental problem is that an under-priced government guarantee rewards irresponsible risk-taking at the taxpayers' expense. The greater its extent, the more it would undermine the soundness of the financial system.

Another argument for action is that 'every other country was doing it'. At least one commentator referred to the decision as a 'no-brainer', presumably for this reason. Such arguments seem to reflect the same mind set as the investment banker who said his organisation remained active in risky mortgage-backed securities because 'while the music is playing, you keep dancing'.

More happily, the fact that many countries have adopted such schemes provides economists with empirical observations that they can use to test their effects. Indeed, there is an extensive literature on the subject. It has recently been independently reviewed by the OECD secretariat[1] and by staff at the International Monetary Fund.[2] Both cite studies that find that explicit deposit insurance schemes tend to increase the frequency of banking crises. Such empirical findings accord with the 'moral hazard' incentive effects that worry economists.

Now of course it is possible that New Zealanders will be cleverer than most other countries and devise a scheme that will 'lead the world' to a better government-guaranteed future. If so, the obvious thing to do would be to develop the clever scheme first and examine it for flaws carefully before deciding to proceed. To expect New Zealand officials to invent a better mousetrap 'on the hoof' would be foolish, except in an emergency.

But at this point we have come back to the question of an emergency. If there was no real emergency, perhaps the real economic problem is an institutional one. Could our institutional framework be improved so as to better constrain rushed economic (or political) decisions? **[]**

1 Financial Turbulence: Some Lessons Regarding Deposit Insurance, Sebastian Schich, Financial Market Trends, OECD 2008.
2 The Determinants of Banking Crises: Evidence from Developing and Developed Countries, Asli Demirguc-Kunt and Enrica Detragiache, September 1997.

FROM THE 2BRED FILE

Grant M. Scobie (grant.scobie@treasury.govt.nz)

Saving remains high as an issue on the economic and political agenda. We spend more than we earn, we rely too much on foreigners, we use too much credit, our investment rates are fine but our productivity is awful, we save too little for retirement and we spend too much on houses – in short we are a profligate, undisciplined mob with screwed up discount rates that constantly leads us into the temptation of instant gratification, abandoning the solid values of our parents and grandparents, who with Calvinistic fervour worked and saved and generally behaved in a way that was prudent.

Clearly, caring governments of all stripes have recognised the need to save us from the inevitable state of penury into which we are heading as a result of our reckless and irresponsible behaviour. Were we to be allowed to continue down this path of self-destruction we would become even more dependent on the state, causing a massive drain on the coffers of future governments. This could only be met by taxing even more heavily the remaining few of us that had not moved to Queensland. And in an ironic twist of policy, that has lead to taking action now (read more taxes now) in order that our kids don't have to pay more taxes in future.

So it will not come as a surprise to readers of ***2BRED*** that this appalling state, brought about by our own misguided and inappropriate behaviour, has spawned a wide range of responses, all designed to help us achieve the state of prudence, self control and financial righteousness that our leaders would wish us to have. A tax break here, a write off for thee, and a subsidy for me – and lo and behold we will all be led to a new and glorious land called "top half of the OECD".

Fortunately for those of us who have trouble keeping all this straight and getting ourselves sorted (apologies to the Retirement Commission: http://www.sorted.org.nz), help is at hand. ***Mary Holm*** is always a source of sensible stuff, and in case you missed it, her 2004 booklet ***Snakes and Ladders: A guide to risk for savers and investors*** (Wellington: Reserve Bank) is good value. Download at http://www.rbnz.govt.nz/news/2004/0162136.html. For up to date commentary, research findings and news from abroad, the Retirement Policy and Research Centre at the University of Auckland has a website that is worth monitoring: see Pension Reforms at http://www.pensionreforms.com/index.aspx.

There are but a handful of economists in the real world who manage to combine sensible economics with journalistic flair. ***Gareth Morgan*** must be near the top of this list and his latest look at how the government is fostering responsible behaviour is entitled ***KiwiSafer: How to keep your money safe in KiwiSaver*** (Auckland: Random House), 2007. Peppered with Morgan's ever so subtle touch of irreverence, this is a wee gem. It will alert you to the "cesspit of malfeasance" (aka the investment funds industry); the "irresponsibly light grip that government is keeping on the regulatory wheel"; that "KiwiSaver is a (risky) investment like any other"; and that despite a "Greek chorus of Reserve Bank governors and cabinet ministers intoning the depth and dire consequences of the 'savings crisis'... it is hard to argue New Zealand has a dearth of national savings." The author is up front in stating his interest as a KiwiSaver provider, and equally forthcoming in a table showing the virtues of Gareth Morgan Investments compared to rest of the bunch. This self-made Kiwi seems to find time to run a consulting and financial services business (very successfully), ride his motorbike (to places on the globe few of us have even heard of), run a substantial philanthropic foundation (to give away his excess retirement funds) and still write books that make the stands at the airports, and are invariably "a good read". Were that more of us dismal mob of economists were so endowed.

Along with savings, taxes are the current flavour of the (election) month. They are too high, they are unfair, they create high effective rates and discourage work and marriage, they should be harmonised ... and so on. And above all they are a good reason to move to Queensland, or the Cayman Islands or wherever. I always enjoy stories that trace out from whence we have come. Perhaps it is a deep seated Marxian view of the inevitability of history. Anyway, do try Paul Goldsmith (2008) ***We won, you lost. Eat that! : A political history of tax in New Zealand since 1840*** (Auckland: David Ling Publishing Ltd) for a perspective on the ingenious ways governments take your money. Fourteen chapters roughly corresponding to each decade since 1840 give an insightful and highly readable account of the passions and politics of taxation. It is notable how the tax system is sufficiently agile to evolve with the growth and mix of economic activity. And nothing much is new. I was reminded of the 1973 budget that introduced a Property Speculation Tax aimed at curbing the activities of evil speculators who were driving up house prices and creating an affordability problem for honest decent Kiwi couples... all of which had a rather familiar ring to it.

Readers of ***2BRED*** have a right to expect that the column will be up to date and include offerings on current events. So let me close with a couple of pieces that should be read by all those caught in the hype of the sub-prime world, the financial crisis and the global shakeup generally. Both stand back and make a well reasoned case that it was government policy that caused the problem and we should be at least a tad sceptical that more intervention is needed as a cure. The first is a blog type piece by Steven Horwitz of the Department of Economics, St. Lawrence University. In a piece entitled ***An Open Letter to my Friends on the Left*** (see http://myslu.stlawu.edu/~shorwitz/open_letter.htm) he argues:

"To call the housing and credit crisis a failure of the free market or the product of unregulated greed is to overlook the myriad government regulations, policies, and political pronouncements that have both reduced the "freedom" of this market and channeled self-interest in ways that have produced disastrous consequences."

In a similar vein, Stan J. Liebowitz has published a paper entitled ***Anatomy of a Train Wreck: Causes of the Mortgage Meltdown*** in the Independent Policy Report of October 3, 2008 (see: http://www.independent.org/publications/policy_reports/detail.asp?type=full&id=30). In short, these pieces ask us to think about whether it was a breakdown of markets, another nail in the coffin of capitalism, confirmation of corporate greed... or, was it the outcome of rational and predictable responses to the incentives created by intervention and regulation? To the extent that the balance of evidence weighs in on the side of the latter, we might want to proceed hastily with caution in solving the problem with treatments that might just make the patient sicker. **[]**

Accountants Sometimes Get It Right (but you have to look carefully)

By Paul V Dunmore[1]

Economists model and try to understand economic reality, while accountants try to report it. Both approaches have limitations: accountants do not have the luxury of being able to make simplifying assumptions, but must cope with highly incomplete markets with great uncertainties, strong information asymmetries, high transaction costs, and unknown distributions of market power among an indeterminate number of players. In response, they have developed pragmatic rules and mindsets; but these introduce various systematic biases into their data.

One issue is that management has various incentives to lie about their performance, or at least to show it in the best light. The polite term is "earnings management", and it has an extensive literature. Accounting standards and auditing are responses that seek to limit earnings management, although they are only partially successful.

Of greater interest is a problem created by incomplete markets: the values of most corporate assets are not observable. In perfect markets, every asset would have a single value: arbitrage would ensure that the cost of replacing an asset, its value in use, and the price to be received from selling it would all be equal. But it is only the departures from such perfection that make business possible at all, and in practice the range between the three values of a single asset may be very great indeed.

Accountants have traditionally fallen back on the one value that is reliably observable: what the asset cost when it was originally acquired. Among other virtues, this has limited the scope of management to manage earnings by manipulating asset values.[2] But in recent years, there has been a strong move towards "fair-value" or "mark-to-market" accounting, to the point that a vineyard is now expected to report the fair value of its vines separately from the value of the field in which they are planted.

Fair value accounting began with land, buildings, and other "fixed" assets, which a firm may choose to value either at historical cost or at market value (the choice to be made independently for each class of assets). The US has never allowed these assets to be revalued above depreciated historical cost, but International Financial Reporting Standards (IFRS) now used in New Zealand not only allow but positively encourage revaluation of these assets to fair value.

Fair value accounting then spread to financial assets, for which there is often an observable market price. "Often" does not mean "always", however, and in the last few weeks there has been an emergency change to IFRS, to allow firms in certain circumstances to avoid writing financial assets down to the values obtainable when markets have seized up. Apparently the economic damage caused by making firms report themselves to be insolvent and triggering default clauses is greater than the problems caused by allowing them to report fictitious values for their assets.[3]

None of this would matter much if there were independent sources of reliable economic data. But in practice, accounting data is often the only kind there is. It finds its way into national accounts, measurements of industry profitability, and so forth. In national accounts, perhaps the biases would average out in an economy in equilibrium (which is to say, never). But industry-level and firm-level analyses are distorted by taking accounting data at face value, since accounting rules tend to have systematically different effects in different industries.

The electricity industry illustrates the problem, and allows us to estimate the size of the effects.[4] The industry uses a revaluation methodology for its generating assets based on the present value of expected cash flows. As part of the justification for recent retail price increases, Chief Executive David Baldwin noted that Contact's return on equity was only 8%, which is a rather low nominal rate of return given that good-quality NZ debt at the time was yielding 5-6% after tax.

There is a strong public interest in ensuring that needed investments in generation and transmission can be expected to earn a reasonable rate of return. Accounting data ought to be able to give a reasonable indication of the *ex post* rate of return, and indeed utility price regulation in the US has used accounting profits as the reference data. The difficulty is that calculated rates of return are hugely influenced by the choice of asset valuation method and of depreciation.

Economists conceive of depreciation as the change in value of an asset, while the public tends to think of it as wear and tear. Accountants, however, measure it as an allocation of either the cost or the fair value of the asset. The most common method is straight-line depreciation, which records an equal expense each year over the asset's useful life. This has little to do with changes in value, but it is a necessary expedient given that asset values are often unobservable because of incomplete markets.

However, because electricity companies do revalue their generating assets every few years, we can recast the accounting information to estimate a true economic rate of return. The table shows this using data for the four main generators for the year ended 30 June 2008.[5] Since generating assets increase in value, at least in nominal terms, the economic depreciation is negative. In contrast, all acceptable accounting methods require firms to report positive depreciation expenses, even for assets whose value is increasing. The increases in value may be recorded from time to time, but are not counted as part of profit.

The results are quite striking. The economic rates of return all cluster in the 10-16% range. Reported rates of return under IFRS are much lower, from 3% to 8%, because positive depreciation reduces reported profits. But rates under US accounting standards (using historical cost) are absurdly high: except for a 10% return for Genesis, the rates are all above 30%. This is

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2 For a public-sector example of manipulating asset values to achieve earnings goals, see Gaa, J. & Dunmore, P. (2007) "The Ethics of earnings Management." *Chartered Accountants Journal* 86(8), 60-62.

3 A similar strategy was adopted in the early stages of the long Japanese recession. The initial reaction was to change accounting rules to ensure that the banks could still report capital in line with the Basel guidelines, thus avoiding the need for regulatory action ("Creative Cooking: How Japanese companies dress up their books to survive", *Far Eastern Economic Review* pp. 64-65, April 9 1998). Not until years later were the banks finally repaired.

4 Other examples include airports and universities, both of whom adopt accounting policies similar to those discussed here, with similar consequences.

5 Since firms do not revalue their assets every year, I have estimated an average annual increase in the value from the amount of the most recent revaluation and the number of years that it covered.

mostly driven by an enormous understatement of equity caused by reporting the assets at their depreciated cost rather than their current economic value.

Accounting standard-setters are now trying to give prominence to a concept of "comprehensive income", which is conventional profit adjusted for whatever value changes are reported in the accounts. This is close to economic income, except that it includes revaluations in the year they are made, so that comprehensive income fluctuates wildly from year to year; it is not reported in many commercial data sources; and for the many companies that use historical cost accounting, there is not even an approximation to economic income.

Economists will not be surprised that traditional accounting data is not well aligned with economic concepts. However, the adoption of IFRS is starting to provide information which comes closer to these concepts, although this information is not embedded in conventional measures of income and asset value, and must be dug out of the statements. Further, anyone using accounting data from the US, where revaluation is not permitted, or from companies that do not use fair-value accounting for their major assets, must understand that the data may show the concepts through a distorting lens and that there is no way to correct for this. []

As reported ($ millions)		**Contact**	**Genesis**	**Mighty River**	**Meridian**
(a)	Profit as reported	237.1	99.1	111.0	128.6
(b)	Depreciation (after tax), generating assets	85.7	44.6	44.6	90.5
(c)	Profit before depreciation (a)+(b)	322.8	143.6	155.6	219.0
(d)	Annual revaluation of generating assets	0.0	0.0	585.2	0.0
(e)	Generating assets as reported	4,052.8	1,463.8	3,041.3	6,006.0
(f)	Equity as reported	2,904.1	1,406.8	2,257.7	4,204.6
	Return on equity, as reported (a)/(f)	*8.2%*	*7.0%*	*4.9%*	*3.1%*
US accounting standards (Historical Cost)					
(g)	Generating assets, net HC basis	1,562.2	1,165.3	1,237.1	2,280.0
(h)	HC depreciation after tax (b)*(g)/(e)	33.0	35.5	18.1	34.4
(i)	HC profit (c) - (h)	289.7	108.1	137.4	184.7
(j)	HC equity (f)-(e)+(g)	413.4	1,108.3	453.5	478.7
	HC return on equity (i)/(j)	*70.1%*	*9.8%*	*30.3%*	*38.6%*
Economic return					
(k)	Average annual revaluation	145.9	47.7	195.1	558.2
(l)	Economic depreciation (b)-(k)	-60.1	-3.1	-150.5	-467.7
(m)	Economic profit (c)-(l)=(a)+(k)	382.9	146.7	306.0	686.8
	Economic return on equity (m)/(f)	*13.2%*	*10.4%*	*13.6%*	*16.3%*

Note: Items (a), (d), (e), (f), and (g) are taken directly from the accounts; (b) is taken from the accounts but adjusted for tax; (k) is averaged over the number of years covered by recent revaluations. Values are in millions of dollars.

Fellowship of the Law and Economics Association of New Zealand

The Law and Economics Association of New Zealand (www.leanz.org.nz) has announced that it has created a Fellowship grade of member and intends to admit the first Fellows in mid 2009. The object is publicly to acknowledge those who have contributed to the study and understanding of law and economics in New Zealand and to encourage others to do so.

The benchmark is 100,000 published words. "Published" means generally available in permanent form, so this includes not only refereed articles but also books, client reports so long as they are generally available and contributions to permanent independent websites such as SSRN.

Fellows will also have to have been members of LEANZ for five years, or pay the shortfall in five years' subscriptions before being admitted.

At present Fellows will be elected by the Committee of LEANZ but once there is a critical mass of Fellows it is hoped to pass this task to the Fellowship, led by the Senior Fellow.

LEANZ hopes to admit the first batch of Fellows at the AGM in mid-year, [and] so anyone interested in becoming a founding Fellow needs to have submitted a formal application accompanied by two copies of the works relied on by 2 March 2009.

Anyone interested in applying for Fellowship now or in the future should contact any member of the Committee of LEANZ that they know, or the President, Bernard Robertson at **bwnr@paradise.net.nz**

LEANZ was founded in 1994 to promote the study and understanding of law and economics in New Zealand. LEANZ holds regular seminars with expert speakers in Wellington and Auckland and supports other activity. The Patron is the Rt Hon Sir Ivor Richardson, and Honorary Members include Professor David Teece of UV Berkeley and Professor Richard Epstein of the University of Chicago. The seminar programmes are run by the Vice-Presidents for Auckland (Gary Hughes, Chapman Tripp) and for Wellington (Merrin Blight, Min of Justice). LEANZ is also interested in supporting "entry-level" study of law and economics by young academics and postgraduate students in both disciplines and anyone interested in this should also contact Bernard Robertson. []

A Rather Embarrassing Global Meltdown

by Stuart Birks (k.s.birks@massey.ac.nz)

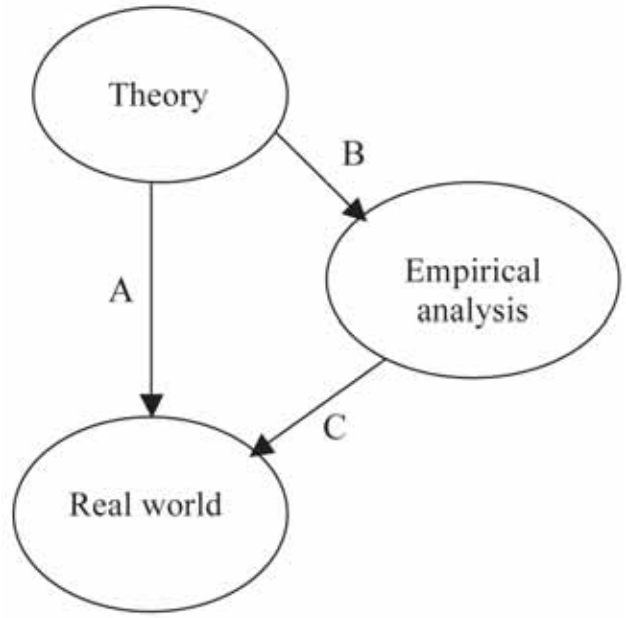
The current international financial turmoil does not do much good for the public image of economics. While problems can be seen clearly with hindsight bias, it should still have been possible for us to recognise that there may be fundamental weaknesses in the economic system. Why were they ignored?

Some of the points raised in past issues of *Asymmetric Information* may help to explain the oversight. Economic theory and econometric estimation commonly assume essentially mechanical relationships with a fixed, stable underlying structure. The reality is that there was a structural weakness and, depending on your paradigm, i) there was a black swan, or ii) a set of INUS conditions occurred, or iii) we reached a tipping point.

So, are economists looking for the right things, or are we assuming away some fundamental aspects of the systems that we are trying to understand? Perhaps our theories and the functional forms that we are estimating fail to incorporate phenomena that can be very important in the real world.

It may be worth considering how we analyse issues. Economic theory, if correctly formulated, should be internally logical. Given the stated assumptions, the conclusions follow. In addition, empirical analysis should meet our requirements in terms of the estimation techniques and the statistical tests used to determine the results. However, these are only components in the process of analysis of real world events. There is still scope for three types of logical errors.

Consider the following diagram:



A type-A error arises when theoretical results are assumed to be directly applicable to the real world.

A type-B error can arise due to data problems, or difficulties specifying relationships and functional forms that match the theory.

A type-C error occurs when incorrect conclusions are drawn from statistical results, either through a misinterpretation of the meaning of the results, or a failure to consider additional, relevant policy dimensions.

Such possible errors, where claims could be considered as rhetorical rather than logically based, are apparent to the point of being trivial. They have been stated several times, and in various ways. For a recent example Arjo Klamer, in a discussion on the structure of argumentation, refers to gaps in the reasoning: "Gaps between the theoretical and empirical arguments have not been bridged, policy implications do not necessarily follow and methodological arguments are, for the most part, seriously flawed." (Klamer, 2007, p. 106)

Nevertheless, the errors repeatedly occur and can, quite rightly, undermine our credibility in the wider intellectual community. Illustrations of all three types of error have been described in past issues of *Asymmetric Information*. Type-A errors are particularly topical at the present time, so here are two more illustrations.

The information prepared for the public on Paul Krugman's award of the Prize in Economic Sciences states that the model shows that foreign trade between identical countries "will arise", intra-industry trade "will occur", and consumers "will benefit" (The Royal Swedish Academy of Sciences, 2008). Models can show what will happen within the model, or what will happen if the world behaves "as if" in the model, but they do not show what will happen in the real world.

On 23 October in the US, the former chairman of the Federal Reserve, Alan Greenspan, appeared before the House Oversight and Government Affairs Committee, where he read a statement (Greenspan, 2008) and answered questions. Here is an extract from an exchange between him and the chairman of the committee, Rep. Henry Waxman:

> WAXMAN : The question I have for you is, you had an ideology. You had a belief that free competitive *[sic]* and this is your statement, 'I do have an ideology that free, competitive markets are by far the unrivalled way to organize economies. We tried regulation. None meaningfully worked.' That was your quote. You had the authority to prevent irresponsible lending practices that led to the subprime mortgage crisis. You were advised to do so by many others. And now the whole economy is paying the price. Do you feel that your ideology pushed you to make decisions that you wish you had not made?
>
> GREENSPAN: Well remember that what an ideology is is a conceptual framework with the way people deal with reality. Everyone has one. To exist, you need an ideology. The question is whether it is accurate or not. And what I'm saying to you is yes, I've found a flaw, I don't know how significant or permanent it is, but I've been very distressed by that fact...
>
> WAXMAN: You found a flaw in the reality...
>
> GREENSPAN: Flaw in the model that I perceived as the

critical functioning structure that defines how the world works.

WAXMAN: In other words, you found that your view of the world, your ideology was not right.

GREENSPAN: Precisely.

(James, 2008)

Greenspan was treating his chosen theoretical perspective as if it were representative of the real world. There was a rhetorical leap, and a leap of faith at that, given that he considered it his ideology.

This is a cautionary tale. Economists have been warned against such errors. Sir Roy Harrod, 70 years ago, said, "[E]conomists, even the most theoretical, have been prone to give advice on the basis of theory" (Harrod, 1938, p. 387). However, when they do this:

> They must say good-bye for ever to the claims to certainty which they could make so long as they remained within the confines of their geometrical system. From being one of the most exact, albeit narrowly circumscribed, sciences, economics of necessity becomes one of the most conjectural. (Harrod, 1938, p. 388)

So theory is not the real world. Perhaps it is worth considering what theory actually is. According to Lipsey:

> "A theory consists of (1) set of definitions that clearly define the **variables** to be used, (2) a set of **assumptions** that outline the conditions under which the theory is to apply, (3) one or more **hypotheses** about the relationships among the variables, (4) **predictions** that are deduced from the assumptions of the theory, and that (5) can be tested against actual data." (Lipsey, 1989, p. 22)

This description focuses on the structure of a theory. With the use of variables and the relationships between them, at its core there is a model. This would fit a conventional view of theory in economics, although point (5) would not apply to pure theory. However, models are not unique to economics. A model is a simplified representation that is intended to highlight the main elements of a phenomenon under consideration. Except for possible differences in the level of formalisation, it is not unlike the approach that a person might take on any issue, as in adopting a stylised or simplified representation of the real world.

Alternative perspectives on theory and models might consider not their structure, but instead their function or use. First, theory can be used to specify a model that relates policy instruments to target/objective variables.[1] The variables are selected according to the objectives and the available instruments. This affects what we see and what is, possibly by default, excluded from the analysis.

Second, the use of theoretical findings might be considered as merely a 'mode of argumentation'.[2] The following discussions of models illustrate this alternative, considering them as forms of **analogy**, **metaphor**, and **attribute agenda setting**, or **framing**.

Klamer, in an economics context, describes a model as, "an explicitly, and in economics often formally, articulated **analogy**. A model is typically characterised by 'as if' reasoning." (Klamer, 2007, p. 123)

Lakoff and Johnson, from a linguistic perspective, focus on the use of **metaphor**, where, "The essence of metaphor is understanding and experiencing one kind of thing in terms of another." (Lakoff & Johnson, 2003, p. 5) With economic models, we generally see economic phenomena in terms of mathematical/mechanical systems. Lakoff and Johnson speak more generally:

> "In all aspects of life, not just in politics or in love, we define our reality in terms of metaphors and then proceed to act on the basis of the metaphors. We draw inferences, set goals, make commitments, and execute plans, all on the basis of how we in part structure our experience, consciously and unconsciously, by means of metaphor." (Lakoff & Johnson, 2003, p. 158)

They distinguish between direct and indirect experience, where indirect experience involves some additional processing or interpretation of information. As such, even consumption activity, such as say watching a comedy film, can include indirect components, but broader policy issues can be entirely indirect. This is particularly relevant for the analysis here, because, "[M]ost of our indirect understanding involves understanding *one kind* of entity or experience in terms of *another kind* – that is, understanding via metaphor." (Lakoff & Johnson, 2003, p. 178) It should be noted that the metaphor highlights certain aspects, "and what is not highlighted is downplayed or hidden." (Lakoff & Johnson, 2003, p. 179) So models and theories could be considered as metaphors which shape our perceptions and understanding.

Communication literature refers to **frames**. Hence Severin, discussing the news media and quoting a conference paper, writes, "A frame can be defined as 'a central organising idea for news content that supplies a context and suggests what the issue is through the use of selection, emphasis, exclusion, and elaboration'." (Severin, 1997, p. 320) As with analogy and metaphor, framing can be widely observed. However, the approach of selection, etc., could also be used to describe theories and model building. Weaver, also in the communication literature, makes a connection between framing and agenda setting. He describes first-level agenda setting, where issues are selected (giving "what"), and second-level agenda setting, where attributes of the issues are determined (giving "how"). The first level could be called simply agenda setting, with the second level being framing (Weaver, 2007, p. 142). The New Zealand Treasury is also aware of framing and agenda setting, as well as the importance of persuasion, as components of the process if giving policy advice. It is not clear whether the framing implicit in the theories is also recognised, however:

> "We frame issues and help set the agenda...Advice is compellingly presented...[Advice is] pitched to suit the target audience – uses appropriate language, style and level of detail." (Whitehead, 2008, p. 26)

To summarise, various bodies of literature have their own terms for very similar phenomena. They all suggest that our understanding is influenced by the perspectives taken, and theories and models perform this function also. Gitlin makes the connection with theories explicit: "Frames are principles of selection, emphasis, and presentation composed of little tacit theories about what exists, what happens, and what matters" (Gitlin, 2003, p. 6). As they affect our perceptions, they may result in distorted understanding. While this could be considered to be bias, Schudson, referring to the news media, gives an alternative, more benign interpretation:

> "In the social sciences, the idea of bias has largely been replaced by that of 'framing'...Framing is as central a concept as there is in the study of news. It moves the analysis away from the idea of intentional bias. That is, to acknowledge that news stories frame reality is also to acknowledge that it would be humanly impossible to avoid framing. Every narrative account necessarily presents some things and not others; consciously or unconsciously, every narrative makes assumptions about how the world works, what is important, what makes sense, and what should be." (Schudson, 2002, pp. 35-36)

Lastly, here is a quote from Richard Feynman, who was awarded the Nobel Prize for physics in 1965:

> "I would like to talk about one more thing, and that is, how do you get new ideas?...That you do by analogy, mostly, and in working with analogy you often make very great errors." (Feynman, 1998, p. 114)

In summary, it is inevitable that theories and models will be used to assist in our understanding, but they are not accurate representations of the real world. They are partial, they may distort, and they may mislead.

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1 Note also a link between models and planning: "We take the term 'planning' to refer to a purposive, means-ends process and we may define it as a deliberative manipulation of the parameters of a system in order to bring about a desired and specified alternation in the operation of the system." (Bowles & Whynes, 1979, pp. 1-2)

2 Mode no.5, reasoning from cause (Dunn, 2004, p. 395)

Paul Krugman, Nobel Laureate in Economic Sciences (2008)

(by James Alvey, J.E.Alvey@massey.ac.nz)

On 13 October, 2008 it was announced that Paul Krugman (Princeton University) would be awarded the Nobel Prize in economic sciences. The citation for his award reads: "for his analysis of trade patterns and location of economic activity." Krugman is famous within the economics profession and in the general public.

Krugman is one of the most well-known economists in the world because of his writings for a general audience. He wrote for a variety of popular or non-technical publications such as *Fortune*, *Slate*, and several others in the 1990s. In 2000 he began writing regularly for the *New York Times* (since 2007 he has also written in an associated blog on nytimes.com). Only a small proportion of Krugman's writings in these outlets was devoted to trade issues. The US President and his policies were attacked in what many saw as a partisan manner in many of these "opinion" pieces by Krugman. A book based on some of these articles has been published (Krugman 2003).

Krugman's turn to writing for the general audience is rather ironic because, in earlier writings, he had denounced Galbraith for doing exactly the same thing. Krugman turned himself into "a Galbraith" during the latter part of his career (see Duhs 2006). If he does end his journalistic career, perhaps Krugman will regret the lost opportunity to advance his "scientific" writings during recent years.

Krugman's work on economic geography was mentioned in his Nobel citation. At a recent seminar I heard Philip McCann speak about the new economic geography (with which Krugman is associated). Except to say that it seems to be an interesting area, I have nothing to say on this area.

I do wish to say something, however, about Krugman's work on international trade theory, trade policy and some other economic areas. In teaching one of the two third-year international trade courses at Massey University in 2008, I used the chapter on strategic trade in the 5th edition of Krugman's international economics textbook (Krugman and Obstfeld 1999). Unfortunately, many of the nice examples of strategic trade (from Japan, the USA, and France) were cut out of later editions (i.e. the 6th and 7th editions) of the text. In the textbook that we used (Appleyard, Field and Cobb, 2008), Krugman's work is mentioned frequently (20 pages of the text). In the trade theory part of Appleyard, Field and Cobb (2008), one section of the textbook is devoted to "the Krugman model." This section is devoted to Krugman's 1979 article on trade theory which uses economies of scale and monopolistic competition to help explain an anomaly in the literature.

The Heckscher-Ohlin orthodoxy explained trade on the basis of factor endowments, which seemed to explain trade between developed and developing countries. On the other hand, this set of theories was deficient on two significant grounds. First, it did not explain the extensive trade that occurred *between advanced economies* (which have similar levels of technology and skilled labour). Second, much of the export and import flows between developed economies seemed to be in *similar goods* (suggesting product differentiation or brand loyalty) . Krugman showed that an explanation for the composition of trade patterns *could* be given if some of the assumptions of the Heckscher-Ohlin-type trade theories were relaxed. This 1979 article was one of the principal papers which won Krugman the Nobel Prize.

Another part of the Appleyard, Field and Cobb (2008) textbook discusses trade policy. In Chapter 15, "Arguments for Interventionist Trade Policies," there is a section on "Strategic Trade Policy". Of the five sub-sections in the section, two discuss models taken from Krugman's work: economies of scale in a duopoly framework; and research and development and sales of a home firm. Both of these models came from a book chapter that Krugman wrote (Krugman 1984). These strategic trade theories could be used to explain, in certain instances, how protection of the home market promotes exports. Krugman took the opportunity to suggest that such theories might help to explain the rise of Japan as a major exporter in the 1970s and 1980s (Krugman 1984, 180). In doing so, he saw himself as a positive scientist. (The gap between Krugman's assumptions and what we observe, however, makes such theories questionable as representations of "the real world" generally and post-war Japan in particular.) Krugman explicitly rejected the usual final step in a work on economics: drawing out policy advice (of course, long ago, David Hume, in what is now called "Hume's Guillotine," ruled out drawing normative conclusions from positive statements). Krugman stated that the moral of his paper was "Certainly not that the US should protect manufacturers as a general strategy" (1984, 192); he did not advise governments to seek out opportunities to protect industries. Krugman remained an advocate of liberalized international trade.

I also used two aspects of Krugman's work in my course on Asia-Pacific Economics. First, I used an article of his that debunked the notion that there was an "Asian [economic] miracle" in the period after World War II. Krugman argued that most of the economic growth that occurred in the East Asian "tigers" was easily explained: it could be attributed to increasing inputs of labour and capital in accord with standard economic growth theory. (Krugman's paper helped to popularize earlier work by Lau and Young). Second, I used his work on the Japanese "economic crisis" in the 1990s and early 2000s. Krugman was one of the first to analyze that "crisis" in terms of the Keynesian "liquidity trap" model (Krugman 1998). It must be remembered that many of the anti-Keynesian economists of the 1980s and 1990s had declared that the liquidity trap could not occur in practice. In time, Krugman's analysis gained popularity to become, in essence, the orthodoxy.

Just as Hayek, Coase, and Mundell were awarded Nobel Prizes for work done decades earlier, Krugman has been recognized for work done 20-30 years earlier. Whether his work in recent times will add much to his reputation is an open question. Before closing, I would like to refer to an anecdote from the recent past provided by a visiting Chinese professor. He stated that Krugman's work was very influential in Chinese government circles. In retrospect, I should have asked whether the Chinese studied Krugman's theoretical work on trade, or his theoretical work on economic geography, or his popular works denouncing President Bush and his policies.)

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RESEARCH IN PROGRESS...

Continuing our series on the research projects currently underway in Economics Departments and Economics Research Units throughout New Zealand, in this issue we profile the research currently being undertaken by economists on the various campuses of Massey University. The objective of this section is to share information about research interests and ideas **before** publication or dissemination - each person was invited to provide details only of research that is **new** or **in progress**.

... economic research at Victoria University as at November 2008.

Compiled by Stephen Burnell, (Stephen.Burnell@vuw.ac.nz)

Geoff Bertram's current research interests include the macro consequences of the recently-announced wholesale deposit guarantee for the New Zealand banking sector; the evolving structure of the New Zealand electricity market; a forthcoming book on the emissions trading scheme; and a project on New Zealand's economic and constitutional role in relation to the Pacific Islands over the past century. He has a forthcoming chapter on twentieth-century economic history in the new edition of the *Oxford History of New Zealand*.

Roger Bowden's research interests include Financial system stability; Financial risk management; Macroeconomics (economic policy; economic growth and stability; international trade); Economic dynamics; Exchange rates; Interest rates; Financial asset and derivatives pricing; Capital markets (equilibrium, disequilibrium, bubbles & contagion); Econometric techniques.

Stephen Burnell is looking at (i) the causes of the fall in New Zealand household saving, and (ii) the relationship between 90-day bank bills and 91-day Treasury bills.

Chia-Ying Chang currently works on the following topics: (1) The effect of FDIs on home countries; (2) Monetary search-theoretical models; (3) New entries on economic growth; (4) Monetary and fiscal policy; (5) market frictions on labour participation rate.

Pian Chen's current research studies econometric methods important for labour economics and corporate finance, including generalized matching methods for program evaluation, nonparametric sample selection models, and corporate default/bankruptcy probability prediction.

Toby Daglish's research covers the areas of derivatives, fixed income securities and portfolio allocations. He is currently working on default risk for mortgage borrowers, collateralised debt obligation pricing and the pricing of floating rate debt in China.

Lew Evans continues his research interest in the behaviour of commodity prices in the presence of transaction costs, and applications of this work to electricity markets with few and multiple agents. He also researches economics issues attending regulation of various sorts and the interaction between law and economics in the regulatory and competition law arenas.

Graeme Guthrie's research interests span topics in economics and finance. He is currently investigating the role of volatility, irreversibility, and competition in housing markets, extending his recent work on the behaviour of commodity prices. He is supervising graduate students who are working on topics such as (i) the implications of managerial risk aversion for the timing of corporate investment and (ii) the interaction between operating flexibility and market power in electricity markets.

Viv Hall has research in progress, jointly with C John McDermott, into various aspects of

New Zealand's business cycles, including draft papers involving: the ongoing development of "A Quarterly Post-World War II Real GDP Series for New Zealand"; "Unobserved components business cycles for New Zealand. What are they, and what might drive them?"; and "An unobserved components common cycle for Australasia? Implications for a common currency".

Stephen Keef and **Mohammed Khaled** are currently investigating the international turn of the month effect with stock index returns from 62 countries. They plan to use their data base to examine the 'frightening' Friday the 13th effect in international stock indices.

Jacek Krawczyk's research interests concentrate on economic dynamics and computational economics. Currently, he is working on (1) "Monetary policy design using viability theory"; (2) "A viability theory approach to technology adoption"; (3) "Toward an understanding of tradeoffs between regional wealth, tightness of a common constraint and the sharing rules"; (4) "Can planners control competitive generators?"

Martin Lally's current research interests are in cost of capital and optimal dividend policy, with an emphasis on taxation aspects.

Dawn Lorimer's research interests are in the areas of Financial Markets and Institutions, Regulation, Risk Management, and Financial Education.

Vladimir Petkov's research interests lie in the area of dynamic games. In particular, he is interested in how commitment and the lack thereof affect agents' behaviour in

long-term strategic interactions. Applications include various topics in industrial organization, such as contract design and firm structure. Furthermore, Vladimir studies normative issues that arise in dynamic settings, such as designing government policies that remedy stock externalities and consumer self-control problems.

John Randal's current research projects include examining the effects of money matching, and researcher scrutiny on donation behaviour; seasonal decomposition using structural break models, with application to the New Zealand short-term visitor arrival series; analysing the effect of heavily rounded prices on volatility estimation; estimating the short-term exchange rate exposure of New Zealand firms.

Leigh Roberts has just presented a paper at an actuarial education conference at Macquarie University. The theme of the paper is briefly that the actuarial profession should refrain from teaching basic undergraduate material when such material is provided at universities; and that actuarial science degrees constitute a suboptimal entry to the actuarial profession, narrowly focusing on passing professional examinations at the expense of pedagogy. Another project on which Leigh would like to work is to fit a model to the insurance cycle, again using hidden Markov models. A further project incepting at the moment is a joint project with Eric Wu at Victoria and Philip Cheng in Sydney, the aim of which is to fit a hidden semi Markov model to stock exchange price data.

Jack Robles is interested in micro economic theory, rather broadly defined. On the more abstract side, he studies evolutionary game theory and the implications of rationality and knowledge (without equilibrium) in games.

On the more applied side, he studies: contractual relationships between attorney and client, entry deterrence through the maintenance of idle productive capacity, and the behaviour of hydro-electric power producers.

John Singleton's main area of interest is twentieth century economic and business history. John is currently working on a book for Cambridge University Press on the comparative history of central banks in the twentieth century.

Paul Tompkinson's current research includes (i) Some errors in the treatment of export subsidies, and (ii) Credibility and the relevance of economic models with untrue assumptions.

Malathi Velamuri is currently working on (1) Gender differences in job turnover, and how these vary with expectations of promotion; a number of collaborations with Steven Stillman relating to (2) Longitudinal impact of crime victimisation on labour market outcomes and well-being; (3) Causal impact of incarceration on labour-market outcomes and well-being; (4) Immigrant self-selection, returns to skills and trans-Tasman migration flows; in collaboration with Pian Chen, a paper on (5) Mis-specification in discrete choice non-linear models; and in collaboration with Paul Frijters, a paper on (6) The impact of the internet on the uptake of high-quality news. **[]**

EMAIL DATA BASE

We are currently setting up an email database of members to keep up to date with technology, and we are working towards eventually e-mailing as many of our notices/publications as possible. If you have not yet supplied the Secretary-Manager with your email address please email: **economists@nzae.org.nz**

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The New Zealand Association of Economists aims to promote research, collaboration and discussion among professional economists in New Zealand. Membership is open to those with a background or interest in economics or commerce or business or management, and who share the objectives of the Association. Members automatically receive copies of New Zealand Economic Papers, Association newsletters, as well as benefiting from discounted fees for Association events such as conferences.

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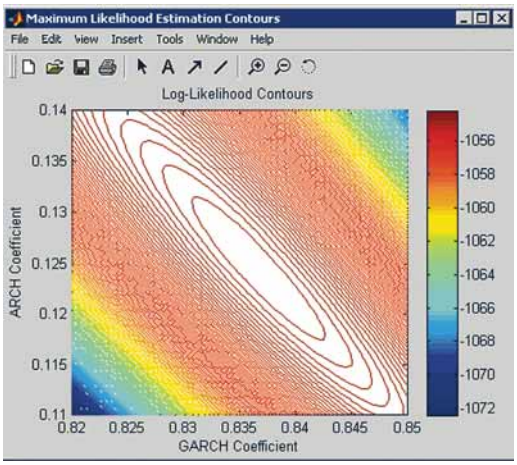

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