A PREMATURE RUSH TO JUDGMENT; THE BOTTOM LINE

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Body

HAVING pursued an ultra-cautious path in his prepared speech to the Australian Business Economists yesterday, Bernie Fraser chanced his arm with an unhedged ***judgment*** during the question period.

Asked whether long-term bond yields and the slope of the yield curve were still indicators of the outlook for inflation, the Reserve Bank governor opined: "They have lost their credibility." He said the reaction of the bond markets had been overdone - an overreaction. The assembled business economists made it clear it was a ***judgment*** with which they concurred.

Such a confident consensus that the markets simply have it wrong strikes me as remarkable.

Economics, despite its pretensions, is far removed from being a science. As described by Mr Fraser yesterday, economic analysis is largely about looking at what happened a few years back when we emerged from the last recession and how we are performing against that experience this time around.

That's not a bad basis to start, but it amounts to little more than a narrow and primitive historicism. Curiously science, which is a subject of much greater intellectual discipline, empirical research and detailed re-evaluation than economics, is rather more humble of its certainties.

How the certainties of scientific thinking change were outlined in a celebrated study by Thomas Kuhn more than 30 years ago where he described the concept of the paradigm shift.

Kuhn distinguished between normal science - the evolutionary period when scientific understanding rests on a secure system of scientific belief - and the revolution, when a new regime of explanation begins to emerge in response to the accumulation

of evidence that runs counter to the dominant paradigm.

Importantly these revolutionary periods of science are not characterised by a simple shift from one paradigm to another but are intellectually tumultuous. A multitude of half-baked ideas compete for intellectual ascendancy with one paradigm finally emerging that explains the disparate phenomena that had eluded comprehension to that point. With general acceptance this paradigm serves as the platform for a new period of normal science, until new discoveries inevitably make this new platform untenable as well.

Kuhn's concept of the dominant paradigm ultimately collapsing under the weight of evidence that cannot be accommodated within its prescription is, I would suggest, a useful platform from which to view the current misfit between economic theory as articulated by Bernie Fraser and what is actually happening in the markets.

Now it could be that the governor and most of the business economic community who believe the markets have simply got it wrong are correct.

From where I sit, however, such a ***rush*** to ***judgment*** is, at the least, ***premature***. The forces involved in the fashioning of market behaviour in the recovery phase from the 1982-83 recession were vastly different from those now evident in financial markets.

Back in 1983 deregulation of financial markets was barely in its infancy. Remember we didn't even float the dollar and remove exchange controls until December 1983. It was some time later that we saw the other other elements of deregulation such as the granting of 16 foreign bank licences, removal of interest rate controls, the dismantling of controls on foreign investment and capital movements, the deregulation

of the stockmarket, alteration of the asset reserve requirements of the banks and insurance industry and the dissolution of the distinction between savings and trading banks.

In 1983 global borrowing on international capital markets totalled $US150 billion; last year it exceeded $US800 billion. Back in 1983 we didn't even have international statistics covering derivatives. By 1986 the global notional value of derivative contracts was around $US1 trillion; today it exceeds $US16 trillion. The areas of greatest activity in the derivatives markets are interest rate swaps followed by interest rate futures and then by interest rate options.

There has also been the revolution of disintermediation, especially but not only in the US market. Household involvement in equity and bond markets is at an all-time global high.

There have also been unprecedented changes in the non-financial markets with the collapse of communism and mercantalism. Ten years ago China was almost another planet as far as the global trading economy was concerned. The Asian tigers were mere cubs and Japan was not the world's largest creditor economy. That honour belonged to the US, which is now the world's largest debtor.

Even though there was a recession in most OECD economies back in 1982 they did not run fiscal deficits on anywhere near the scale they ran last year. Nor were they bedevilled by double-digit unemployment, which is going to make winding back those fiscal deficits a major political challenge.

Despite these monumental changes in the financial and nonfinancial markets the yardstick applied to market behaviour today is the same as it was back in 1983.

Now I would not be so radical to claim that the market is not overreacting; markets do that sort of thing from time to time. But I keep hearing at the back of my mind: "Beware the dominant paradigm."

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