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The biggest intellectual scandal of our time

Editor

If mainstream economists had thought and behaved differently after 1980, then arguably the world would not be in its current state of disarray, and much of the social and environmental dislocation that we have witnessed over that time-span would not have occurred. In a nutshell, these economists uncritically accepted as true the false analyses, promises and prescriptions of neoliberal ideology. The destructive outcomes of their attempts to implement those prescriptions were greatly enhanced by their profound ignorance of the operational dynamics of finance, banking and credit money creation. To this day they continue to hold to barter-based models of economic activity, to the extent that money, credit and banking are missing from their considerations.

Mainstreamers possess several major blind spots. Firstly a failure to recognise the important role that the creation and flow of bank credit money plays in the evolution and development of every modern economy, through its essential contribution to income, aggregate demand, employment and economic performance. Secondly, they think that private debt growth does not affect economic performance. Thirdly, they think that every economy tends towards a stable equilibrium configuration. Fourthly, they think that private borrowing, spending and saving are always driven by "rational expectations". Fifthly, they think that public debt (i.e. deficit spending) should be minimised, consistent with what they imagine is the universal validity of the "crowding out" hypothesis - which falsely asserts that public borrowing always crowds out private borrowing, leading to rising inflation and rising interest rates.

And lastly, they hold to the idea that commercial banks do not create the money they lend and spend into the economy. But rather, they hold to the "loanable funds" hypothesis, which asserts that banks are able to on-lend their depositors' funds. The reality however is that neither bank credit money nor reserves are ever loaned out to a bank's retail customers. Moreover bank credit money creation occurs endogenously, meaning that banks lend or spend first and look for the regulatory reserves they might happen to need later. Central banks are always able and willing to provide the reserves that the aggregate of commercial banks require for their business operations. Flying in the face of this reality is the belief of mainstream economists that reserves are created *proactively* - under the discretionary control of the central bank - rather than *reactively* in association with their open market operations.

It seems that central bankers know a good deal more about these matters than do mainstream economists. This is evident from a 2017 monthly report on the dynamics of bank money creation produced by the Deutsche Bundesbank and also a similar 2014 report produced by the Bank of England The BoE report referred to here was discussed in a previous issue of ERA Review [v7, n4, 2015; p15]. The findings of these reports are quite inconsistent with the false beliefs held by mainstream economists that we have listed above. Unfortunately, if their past history is anything to go by, that is unlikely to change the views of many of the (neoclassical) mainstreamers, who will simply adopt the tactic of ignoring the existence of these reports.

Neoliberalism Doesn't Work
It doesn't do what it says it can, and we can prove it
Steven Hail

The U.S. economy grew in the 1950s and 60s at an average annual rate of 4.4%; in the 1970s and 80s, at an average rate of 3.2% per annum; in the 1990s and 2000s, on average by 2.5% per year; and since 2010 it has grown by about 2.2% each calendar year.

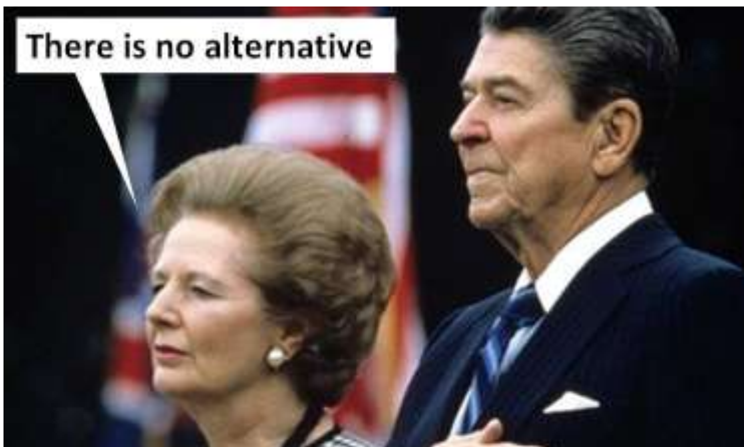
Now economic growth should not be the be-all and end-all of economic policy, for sure. Growth which continues to destroy our eco-system is not something we can afford in the future.

Moreover, other issues like income and wealth inequality which could possibly, under some circumstances, conflict with the objective of higher growth are also important. This is particularly so, given the evidence that increases in income, beyond a certain point, don't appear to add much to our sense of subjective well-being, and that by a variety of metrics, successful societies have been shown by social researchers to be more equal and more equitable ones, rather than necessarily those with the highest incomes.

And yet, we have put up with orthodox economists for generations now, and they have been drumming into our heads the following messages:

- Maximising economic growth is the over-riding objective of policy
- Reducing the higher personal tax rates and making the tax system less progressive sharpens incentives for investment and risk taking and raises productivity growth
- Budget surpluses, or at the least balanced budgets, promote economic stability and growth
- A deregulated and bigger financial system promotes economic efficiency and growth
- The best way to promote social well-being is to cut top tax rates, deregulate, financialise, and allow those at the bottom to benefit from the higher growth via a trickle down effect.

A short article such as this is not the



place to conduct a thorough scientific assessment of these claims, but let's attempt to take them seriously, just briefly. And let's do it for the U.S. only, because after all it is the U.S. which has long been the bastion of trickle down and the rest of the monetarist orthodoxy which took over policy in the 1970s.

Now, go back to the first paragraph, and consider what has happened to U.S. economic growth since the days of Keynesian economic management, full employment and falling inequality of the immediate post-war years. In particular, how did the 70s and 80s compare to the 50s and 60s? OK, the 70s included two oil price shocks, so this might be seen as an unfair comparison. So how did the 90s and 00s compare to the 70s and 80s? OK, the 00s included the Great Recession, so perhaps you see this as unfair. What about 2010-16? Can you see a pattern? By their own metric, the orthodox economists appear to have failed in the U.S. The promises they made back in the 1970s and 80s have not been met.

Perhaps it is easier to see this using a graph (see Figure 1). Here you go, U.S. economic growth since 1950. It's not going up, up, up, is it? Don't forget that this might not be your or my objective, but it was the objective of the people who took over economics a generation or two ago.

Now let's take a quick, and so not very scientific, but honest look at the top marginal rates of income tax in the US. (see Figure 2). I don't need to give you any figures this time – the chart speaks for itself. Look at the top tax rate in the 50s under Eisenhower, or the 60s and 70s under Nixon. Communists! They make Bernie Sanders look like Milton Friedman. And they make Jeremy Corbyn seem positively Thatcherite by comparison.

It is interesting, isn't it, that the cuts in the top personal tax rates have been combined not with an acceleration of enterprise and growth, but with the

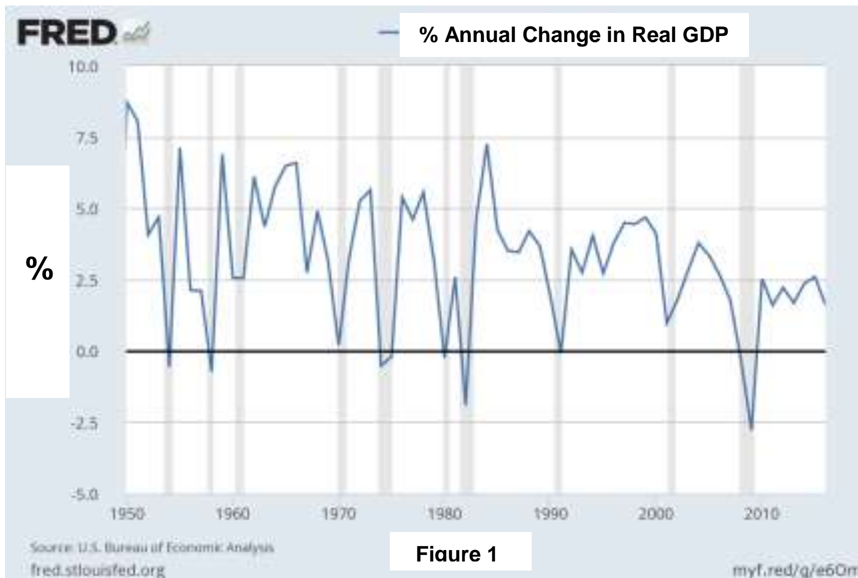


Figure 1

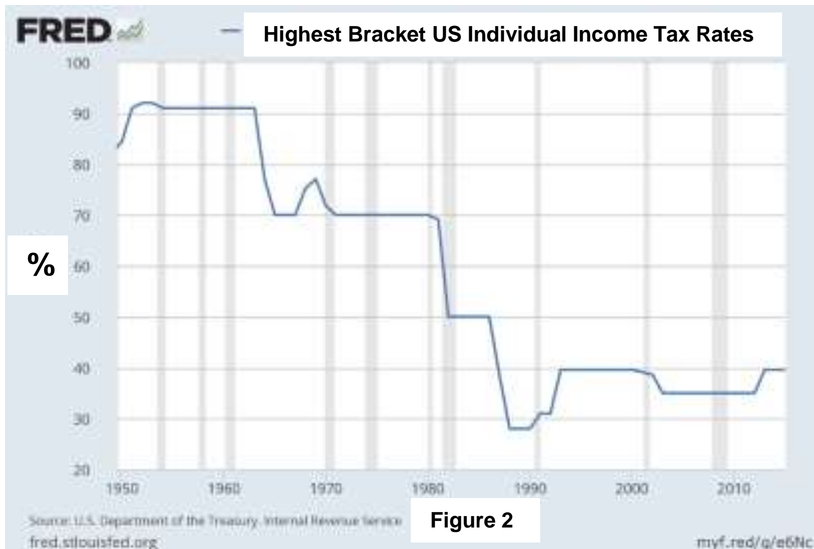


Figure 2

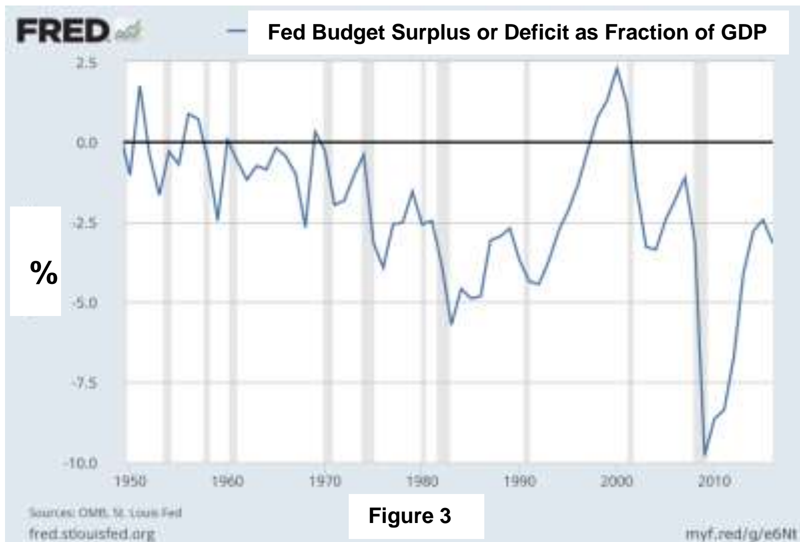


Figure 3

precise opposite. The results have been the opposite of the stated objectives. What can we say about the fiscal balance – budget deficits and budget surpluses? See Figure 3.

The first thing to say is that the federal U.S. government, like virtually all other sovereign governments, does not, has not and will not in the future 'balance the budget' or run surpluses over time. A balanced budget law would be economic suicide. The U.S. government ran (tiny) surpluses very briefly twice in the 50s and again in the 60s, each time being followed by economic downturns, as you can see in the earlier chart. The

only other ‘surplus’ was the Clinton one, which Bill and Hillary and their friends still like to boast about, but which was combined with an unprecedented build up in household debt, and bubbles which burst in both the stock market and then (catastrophically) in the housing market.

The lesson from history, and from basic national income accounting, is that if the private sector overall wishes to add to its savings and if the rest of the world wishes to acquire U.S. dollars (and this became strongly the case after the year 2000, as China and others decided to accumulate large amounts of US dollar reserves) then a fiscal deficit will be necessary if the economy is to remain anywhere close to full employment, without a private debt fuelled bubble taking place. The fiscal deficit after the year 2000 was not large enough to off-set growing trade surpluses of countries like China with the U.S., on which those countries were basing their growth strategies, setting the stage for a crisis.

Remember that the U.S. government cannot ever run out of U.S. dollars, unless it chooses to do so (‘debt ceiling’ anyone?). It is the currency issuer. They can and almost certainly will run budget deficits nearly all the time for ever (or until there is no longer such a thing as the US government).

What about social well-being? The U.S. has always had a relatively high level of inequality, but as many people have pointed out in recent years, the changes which have taken place there since the 1970s have taken this to a new level, or rather back to an old pre-1930s level. We are back in the Great Gastby, 1925, Scot Fitzgerald, and all that. You want to know were Donald Trump came from? Screwing down ordinary Americans, while brainwashing them with lies about their living in a land of opportunity, and berating complaints as being born out of jealousy, or what we Australians might call the tall poppy syndrome, or worse still - and horror above all horrors - socialism!!!

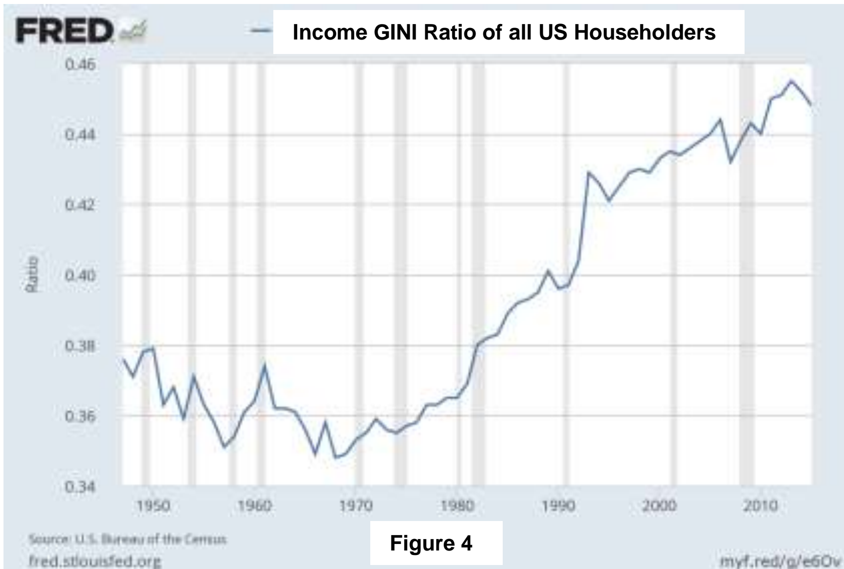


Figure 4

The Gini coefficient is a measure of inequality which lies between 0 and 1, where higher values indicate more inequality. You don't need to know the details to understand what Figure 4 is telling you (and bear in mind this is for income and not wealth, where the data would be even clearer).

Inequality was continuing to fall somewhat, in the golden years up to about 1970, since when it has skyrocketed so that the US now has income inequality typical of a third world country, and not of a civilised and successful society. We are back in the belle epoque for the rich. Pass the champagne, Donald!

The economist Pavlina Tcherneva has produced a highly informative chart (see Figure 5), which can be accessed on her web page. What it shows you is that until the 1970s most of the income growth during periods of economic expansion went to the bottom 90% of the population: since then, most has gone to the top 10%, and increasing the top 1%. During the period from 2009-12, under the champion of the elite Barack Obama, so much went to the top 10% that the bottom 90% actually went backwards. The economy was growing, unemployment was falling, but people's incomes were actually falling. Not much trickle down there!

I could reproduce another U.S. chart to show that hardly any of the very substantial growth in U.S. labour productivity since the early 1970s has gone to U.S. workers in real wages, and consequently nearly all of it has gone to capitalists and investors.

Perhaps it is important to emphasize at this point that this is not a purely U.S. phenomenon. These trends have developed later in countries like Australia, than in the U.S., and in most cases have not gone so far, but we can see a similar story in the Australian data, reproduced in a chart from the blog site of Professor William Mitchell of the University of Newcastle, NSW (see Figure 6).

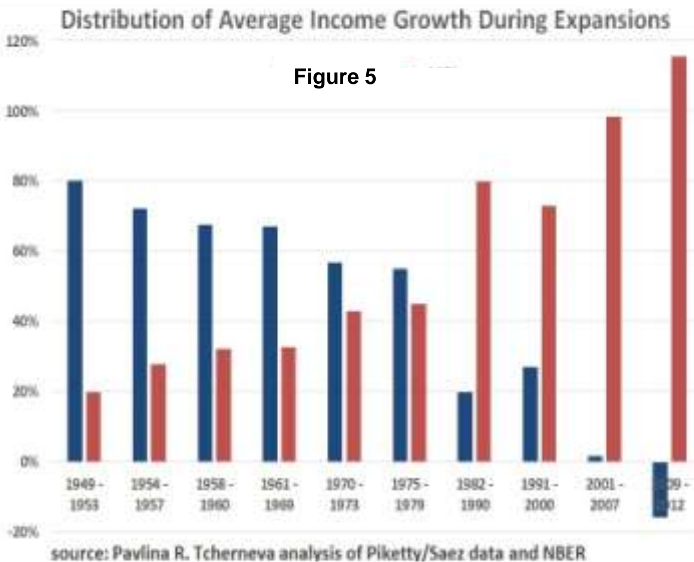
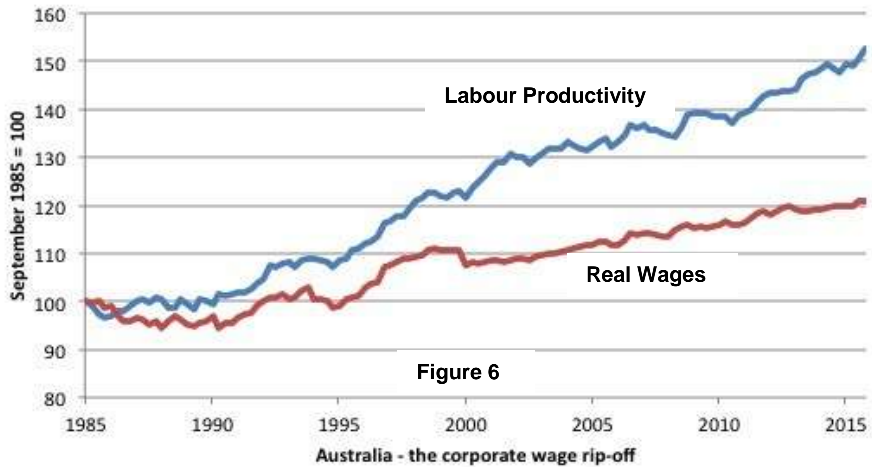


Figure 5



Source: http://bilbo.economicoutlook.net/blog/

And how did that deregulated financial system go? The economist Hyman Minsky, a long time ago, explained that a deregulated financial system would tend to take on more and more risk during times of relative economic stability, and consequently become increasingly fragile, leading to more frequent and more severe financial crises and to eventually a Great Recession. He classified economic management which did not take this tendency into account as 'inept'.

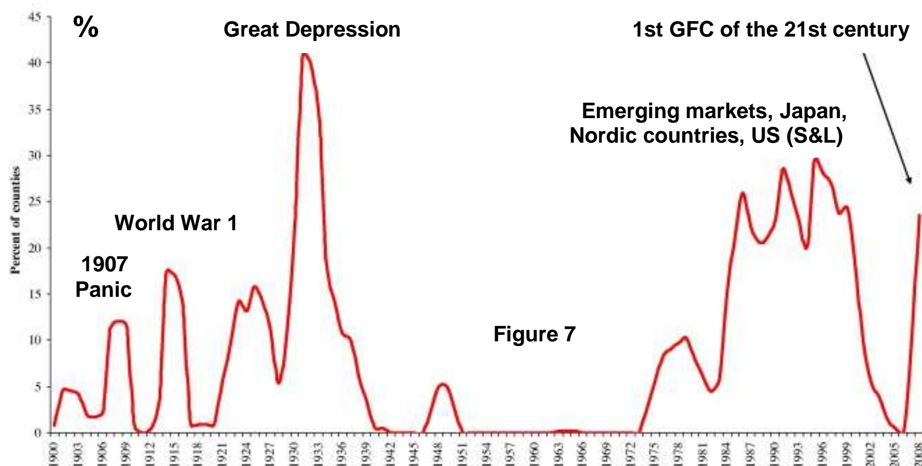
One more chart might be helpful. This is taken from a 2013 paper of two leading orthodox economists, who are hardly radicals - Carmen Reinhart and Kenneth Rogoff (see Figure 7).

The 1950s and 60s are a unique period in global economic history. A period of economic growth, falling inequality in many countries, rising living standards, and virtually nothing which could be described as a banking or financial crisis. And yet, even by the late 60s, Minsky and a few others started to warn of a drift towards fragility and a loosening of the regulations which had allowed this unparalleled period of financial stability to exist. By the end of the last century, almost the whole of the regulatory framework put in place during and after the Great Depression to stop 'It' happening again had been dismantled. It seems that the U.S. and the rest of the world wandered ineptly towards the Global Financial Crisis of the previous decade, at least in part through ignoring economists like Hyman Minsky and choosing instead the economics of Milton Friedman and the neoliberals.

What's more, policy makers, sometimes deliberately and sometimes because they don't dare face the truth, have in most cases not yet taken in, or taken seriously, any of the above.

To be sure, economic growth for the sake of growth is not what we should aim for – it is indeed 'the ideology of the cancer cell', to use the words of Edward Abbey. But there is no evidence that less progressive taxes have promoted growth anyway. There is no evidence that more inequality has contributed

Proportion of Countries with Banking Crises, 1900-2008
Weighted by their share of world income



towards growth. There is no evidence that deregulation has contributed to growth or to stability or social well-being. There is no credible evidence that trickle-down economics works. None whatsoever. It is a fallacy. An article of faith, perhaps – but not of science

Almost everything which almost all policy makers have taken for granted and asked us to take for granted for more than a generation has been proved wrong. We were closer to the truth, it seems, in the 1950s and 60s, and there must be some lessons for us there.

Some economists like Mitchell and Tcherneva - whose charts I have reproduced - and some other modern monetary theorists, and politicians like Bernie Sanders and Jeremy Corbyn, have had some success in bringing the above to wider public attention. They don't advocate a return to the economics of the 1960s, but they and other do advocate an abandonment of the economics and politics of neoliberalism (and of 'New Labour' and the 'Clinton Democrats'), and a shift to a modern progressive, inclusive and equitable approach to economic policy and political decision making.

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The surest way to corrupt a youth is to instruct him to hold in higher esteem those who think alike than those who think differently. - Friedrich Nietzsche

The truth may be puzzling. It may take some work to grapple with. It may be counterintuitive. It may contradict deeply held prejudices. It may not be consonant with what we desperately want to be true. But our preferences do not determine what's true. We have a method, and that method helps us to reach not absolute truth, only asymptotic approaches to the truth - never there, just closer and closer, always finding vast new oceans of undiscovered possibilities. Cleverly designed experiments are the key. - Carl Sagan

The counter-intuitive dimension of economic reality

Edward Fullbrook

Scientific education entails taming the authority of one's intuition. Responsible citizenship in a democracy may entail it as well.

Keynes argued that the markets often create inaccurate expectations of economic reality which people then act upon thereby changing reality. This reflexivity that Keynes identified as central to capitalist markets is the opposite of the basic process described by traditional economic theory, both in Keynes' day and in our own, whereby it is assumed that market expectations are determined by market reality rather than one of that reality's determinants.

For most people Keynes' theory of market expectations, like his theory of aggregate demand, is counterintuitive, and therefore difficult to elucidate and popularize sufficiently to become part of public discussion. That is why George Soros's role as a populariser of Keynes' theory of expectations is potentially significant.

It is my view that in democratic societies the ultimate obstacle to implementing and maintaining laws and policies that make their economies function reasonably well and fairly is the challenge of intellectually enabling their populations, especially their pundits and politicians, to comprehend the counter-intuitive dimensions of economic reality.

Without that comprehension democratic societies will always be highly vulnerable to accepting the advice that follows from economic reasoning which excludes counter-intuitive propositions and which serves the interests of tiny but powerful minorities.

Source: The above observations from Edward Fullbrook appeared in the June 15, 2017 blog of Real World Economic Review.

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Mainstream monetary theory - neat, plausible, and utterly wrong

Lars Syll

In modern times legal currencies are totally based on fiat. Currencies no longer have intrinsic value (as gold and silver). What gives them value is basically the legal status given to them by government and the simple fact that you have to pay your taxes with them. That also enables governments to run a kind of monopoly business where it never can run out of money. Hence spending becomes the prime mover and taxing and borrowing are degraded to secondary acts. If we happen to have a depression, the solution, then, is not austerity. It is spending. Budget deficits are not the major problem, since fiat money means that governments can always make more of it.

Financing quantitative easing, fiscal expansion, and other similar operations, is made possible by simply crediting a bank account and thereby – by a single keystroke – actually creating money.

One of the most important reasons why so many countries are still stuck in depression-like economic quagmires is that people in general – including most mainstream economists – simply don't understand the workings of modern monetary systems. The result is totally and utterly wrong-headed austerity

policies, emanating out of a groundless fear of creating inflation via central banks printing money, in a situation where we rather should fear deflation and inadequate effective demand.

The mainstream economics textbook concept of money multiplier banking assumes that banks automatically expand the credit money supply to a multiple of their aggregate reserves. If the required currency-deposit reserve ratio is 5%, the money supply should be about twenty times larger than the aggregate reserves of banks. In this way -- the money multiplier explanation asserts -- the central bank controls the money supply by simply setting the required reserve ratio.

In his Macroeconomics – just to take an example – Greg Mankiw writes:

" We can now see that the money supply is proportional to the monetary base. The factor of proportionality … is called the money multiplier … Each dollar of the monetary base produces m dollars of money. Because the monetary base has a multiplied effect on the money supply, the monetary base is called high-powered money. "

The money multiplier explanation of banking – as expressed in the quote above – is nothing other than a fallacy. It is not the way in which credit money is created in a monetary economy. It's nothing but a myth that the monetary base can play such a decisive role in a modern credit-run economy based on fiat money.

In the real world commercial banks extend credit first and then look for the reserves later. So the money multiplier explanation basically gets the causation wrong. At a deep fundamental level the supply of money is endogenous.

One may rightly wonder why on earth this pet mainstream neoclassical fairy tale is still in the textbooks and taught to economics undergraduates. Giving the impression that banks exist simply to passively transfer savings into investment, it is such a gross misrepresentation of what goes on in the real world that there is only one place for it -- and that is in the garbage bin.

Source: Real-World Econ Rev, 24 Jun 2017
https://rwer.wordpress.com/2017/06/24/mainstream-monetary-theory-neat-plausible-and-utterly-wrong/

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We are throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity. I suspect that the immense power of the computer is being harnessed to this 'paper economy', not to do the same transactions more economically but to balloon the quantity and variety of financial exchanges.

For this reason perhaps, high technology has so far yielded disappointing results in economy-wide productivity. I fear that, as Keynes saw even in his day, the advantages of the liquidity and negotiability of financial instruments come at the cost of facilitating nth-degree speculation which is short-sighted and inefficient. -- James Tobin

Source: "On the Efficiency of the Financial System." Lloyds Bank Review 153: 1-15 (pp. 14-15).

Environmental degradation is an iatrogenic disease induced by economic physicians who treat the basic malady of unlimited wants by prescribing unlimited growth.... Yet one certainly does not cure a treatment-induced disease by increasing the treatment dosage.

— Herman E. Daly, Steady-State Economics: Second Edition With New Essays

Letters

From John Rawson (NZ)

Understanding inflation

Cost-push inflation may be more important than the demand-pull variety

May I extend the excellent comments on inflation by the Editor in the May-June “Review”?

First, two observations: In the late 70’s and early 80’s New Zealand was, under the Finance Minister Roger Douglas, leading the world into trendy neoliberalism. The volume of money was slashed savagely, but inflation kept climbing. For a while, businesses were paying interest at over 30% for their finance. Second, some years later, the Reserve Bank raised its interest rates to counter an increase in the price of oil, when presumably more money was drained out of circulation to acquire the extra overseas funds needed to buy it.

No wonder “theories used to forecast it (inflation) just don’t seem to work” when economists neglect taking cost-push inflation into account.

What’s more, increasing interest rates or taxes can be inflationary! “Lunatic fringe” comment? Maybe, but I can show that it is right and so can anyone with a knowledge of business, simply by considering markups. More accurately than by the model I used because I believe that I underestimated them.

Let’s firstly get rid of the idea that all business is exploitive and can absorb large increases in taxation. In a competitive situation they must pass all such costs into prices, suitably marked up to cover associated costs, thus enabling them to make a reasonable profit. The alternative is bankruptcy. If some firm does have a monopoly, it is likely to do so at greater cost levels anyway.

A dollar taken at retail level will, therefore, result in an increase in the price level of somewhere between $1.10 and $2 or more. Taxes etc. at lower levels of production will be compounded through succeeding stages so that $1 could be compounded to $2.60 or more at price level.

In passing, here is a warning for those advocates of a “Universal Income” who assert that it must be funded from taxation. Taxing industry would defeat its purpose by raising prices well above the level of the sums paid out.

Finally: “It has been commonly believed within financial markets that inflation is ultimately a function of how much money a central bank creates." Having spent considerable periods of my life trying to persuade electors that our Government should, as it did in the early days of our first Labour government, make use of Reserve Bank credit for some of its expenditure on infrastructure, I only wish this could be possible. But not enough to cause demand inflation, of course. Central banks create reserves for the banking system, and effectively also create money in circulation whenever they purchase financial assets from the non-bank private sector. They do this, like our Government does, by instructing the payee's bank to create bank credit money in the payee's account.

It is difficult to get a man to understand something, when his salary depends upon his not understanding it. -- Upton Sinclair

From Richard Giles
Public finance without debt

Two articles in the ERA Review Vol 9 No. 4 (pp.9-14) advocate using a state-owned bank to provide credit to fund public infrastructure. To my mind such a method of funding infrastructure would work. But that is the problem.

Henry George argued that any measure which added to the wealth of the community, as this measure would certainly do, must also add to land values. Those fortunate enough to be in possession of these land values would perhaps welcome such a measure. Even though they will have missed out on the opportunity to own privatised roads and railways, power plants and water supplies, they will doubtless be glad to be made that much wealthier.

They will also know that government has discovered a way of public finance that leaves this enormous stream of income from land values even more safely in their hands.

Henry George argued that this wealth produced by the community, when spent upon public works and other common benefits, enlarged its own 'tax base'. Thus, the credentials for this 'single tax', from both a fiscal and ethical perspective, were sound.

In the context here George's point of view would seem to be that if the fund for infrastructure already exists why borrow. Could it be that China's many billionaires are actually already beneficiaries of China's way of public financing?

There is no reason to rule out credit financing for business. Indeed, the present banking system, where much of business depends upon privately held funds, seems historically to be just another way by which the 'ruling class' keeps command over the rest of us.

Editorial commentary:

Ellen Brown's suggestion for funding infrastructure was originally framed within the context of a bank owned by a state which is not a monetary sovereign, taking the State Bank of North Dakota as an example. The profits from such a bank would provide revenue for the state. When using the word 'government' it is important to distinguish between a monetary sovereign (usually the central government if there is a federation) - which creates and issues the nation's currency - and all other levels of government. If the central government is unable or unwilling to provide adequate grants to the state governments, then their infrastructure spending would need to be accommodated by finding revenue from (a) taxes and other charges, (b) borrowing, or (c) profits from state-owned banks and other enterprises.

In regard to infrastructure projects funded by a currency-issuing central government, any deficit spending can be accommodated by either direct borrowing from the central bank (CB) or by borrowing from the private sector. The notional debt incurred by either route is never a problem, because a government in debt to its own CB is not really in debt at all, while a monetary sovereign's debt to the private sector can always be serviced.

The Georgist alternative to these methods of public financing relies on imposition of a levy on income obtained from land values. In other circumstances the land values in a city will inevitably increase whenever public investment in infrastructure occurs. In 1977, Joseph Stiglitz wrote a paper demonstrating that, under certain conditions, beneficial public investments will increase aggregate land rents (a form of unearned income) by at least as much as the investments cost. This proposition was dubbed the "Henry George theorem".

The future of economics

Steve Keen

Economics is a divided and lost discipline. Pretending everything is okay is choking off paths for understanding how the economy works and should work.

At the beginning of the Millennium, economics was triumphant. George W Bush's economic advisor Ed Lazear published a paper entitled "Economic Imperialism", in which he argued that economics was the only true Social Science, and could and should supplant its academic neighbours. The President of the American Economic Association Robert Lucas declared that "macro-economics ... has succeeded: its central problem of depression prevention has been solved".

Then the "Global Financial Crisis" hit in late 2007, catching leading economists and policy bodies like the OECD completely by surprise.

A decade later, economics is a divided and lost discipline. Some economists, like former Bank of England Monetary Policy Committee member David Miles, excuse the failure to anticipate the crisis on the basis that this was caused by an unpredictable random shock: "Any criticism of economics that rests on its failure to predict the crisis is no more plausible than the idea that statistical theory needs to be rewritten because mathematicians have a poor record at predicting the winning lottery ticket numbers", he wrote (David Miles, "Andy Haldane is wrong: there is no crisis in economics", Financial Times, January 12 2017).

But others, like his U.S. counterpart Narayana Kocherlakota, President of the Minneapolis Federal Reserve from 2009-2015, argue that both the crisis and the prolonged slow recovery from it show that economics is in crisis, because economists "simply do not have a settled successful theory of the macroeconomy". Echoing the demands of the "Rethinking Economics" student movement that began in Manchester, Kocherlakota called for a plurality of approaches to economics to be developed: pretending that everything is OK with economics, he said, is "choking off paths for understanding the macro-economy."

I side firmly with Kocherlokota and the Rethinking Economics student movement: economics is in need of serious

change. But this is unlikely to come from within the academic discipline itself. The 2008 crisis simply exposed flaws in the dominant approach to economics that critics like myself have been pointing out for decades. Our criticisms were ignored by the mainstream, but they were valid then, and remain valid today. It took the economic crisis to make this obvious to the general public.

The mainstream approach to economics treats capitalism as inherently stable, and builds models of the economy that ignore the existence of banks, debt and money. It's no wonder they didn't see the crisis coming. Only after the crisis occurred have they started to tack a financial sector onto their models, but these models still start from the presumption that the economy is inherently stable.

In a way economists are just being human: as Max Planck found out at the turn of the 20th century when he tried to persuade his scientific contemporaries to accept quantum mechanical ideas, it's near impossible for someone who has been raised within a well-established intellectual framework - in his case, Maxwell's electromagnetic model - to adopt a radically different one, even if it is manifestly better at explaining reality. "Science", he lamented, "progresses one funeral at a time".

Funerals alone aren't enough in economics however, because this academic discipline is uniquely shielded from the real world. Without having the benefit of controlled experiments which can flatly contradict a superficially appealing theory, the discipline continues to promulgate its beliefs, regardless of its manifest real-world failures. Critical students are normally repelled from the subject; compliant ones go on to be future Professors of Economics (with some notable exceptions).

In the 21st century, it is no longer necessary to make 19th century assumptions about equilibrium, or to ignore money when modelling the economy. Models of the economy that make neither of these assumptions—in particular, those built by the late Wynne Godley, or informed by Hyman Minsky's "Financial Instability Hypothesis"—warned that a crisis was inevitable, simply by showing that trends in private sector indebtedness were unsustainable.

There is a vibrant community of non-mainstream economists continuing Minsky's and Godley's work, but they labour at low-ranked Universities with very limited research funding, because the mainstream dominates the top-ranked ones and disparages rival approaches. Change will have to come from outside academia, since Central Banks, Treasuries and business cannot afford the luxury of following fantasy theories of the real world. The rebels, amongst student movements and inside Central Banks, deserve the public's support.

Source: https://www.patreon.com/ProfSteveKeen/posts

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Anyone who believes that exponential growth can go on forever in a finite world is either a madman or an economist. — Kenneth E. Boulding

Economics is extremely useful as a form of employment for economists. — J K Galbraith

Renewable energy will be the cheapest form of power almost everywhere by 2020

Wind turbines have become increasingly efficient, as longer wind blades have been developed.
Photo source: Flickr CC

An article published in *The Independent* by Harriet Agerholm [1] draws attention to a report by analysts at the investment company Stanley Morgan, which says that prices for clean energy are expected to soon fall below prices for more polluting energy sources. This also means that even though president Donald Trump has pulled out of the Paris climate change accord, the U.S. will meet its commitments in the agreement.

The report says specifically that, with the exception of a few Southeast Asian countries, renewable energy sources will provide the cheapest form of new power generation in almost every country by 2020. According to the report:

" By our forecasts, in most cases favourable renewables economics rather than government policy will be the primary driver of changes to utilities' carbon emissions levels.

" For example, notwithstanding that President Trump has withdrawn the U.S. from the Paris climate accord, we expect the U.S. to exceed the Paris commitment of a 26-28 per cent reduction in its 2005-level carbon emissions by 2020."

In this regard, it is significant that "the price of solar panels fell by 50 per cent between 2016 and 2017", the authors of the report said. They added that wind turbines, too, had become significantly more efficient, as scientists have developed longer wind blades.

1. The Independent, 17 July 2017 http://www.independent.co.uk/environment/renewable-energy-cheapest-power-form-country-2020-paris-agreement-climate-change-us-donald-trump-a7844671.html

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If you owe your bank a hundred pounds, you have a problem. But if you owe a million, it has. — John Maynard Keynes

The time to repair the roof is when the sun is shining. — John F. Kennedy

What can Tesla’s giant South Australian battery achieve?

Ariel Liebman and Kaveh Rajab Khalilpour

Tesla PowerPack batteries in Mira Loma, California, 30 Jan 2017 REUTERS/Nichola Groom

Recently, world-famous entrepreneur Elon Musk jetted into Adelaide to kick off Australia’s long-delayed battery revolution. The Tesla founder joined SA Premier Jay Weatherill and Romain Desrousseaux, the international chief executive of French windfarm developer Neoen, to announce what will be the world’s largest battery installation.

The battery tender won by Tesla was a key measure enacted by the South Australian government in response to the statewide blackout in September 2016, together with the construction of a 250 megawatt gas-fired power station.

The project will incorporate a 100MW peak output battery with 129 megawatt hours of storage alongside Neoen’s Hornsdale windfarm, near Jamestown. When fully charged, we estimate that this will be enough to power 8,000 homes for one full day, or more than 20,000 houses for a few hours at grid failure, but this is not the complete picture.

The battery will support grid stability, rather than simply power homes on its own. It’s the first step towards a future in which renewable energy and storage work together.

How Tesla’s Powerpacks work

Tesla’s Powerpacks are lithium-ion batteries, similar to a laptop or a mobile phone battery.

In a Tesla Powerpack, the base unit is the size of a large thick tray. Around sixteen of these are inserted into a fridge-sized cabinet to make a single Tesla “Powerpack”.

With 210 kilowatt-hour per Tesla

Powerpack, the full South Australian installation is estimated to be made up of several hundred units.

To connect the battery to the South Australian grid, its DC power needs to be converted to AC. This is done using similar inverter technology to that used in rooftop solar panels to connect them to the grid.

A control system will also be needed to dictate the battery's charging and discharging. This is both for the longevity of battery as well to maximise its economic benefit.

For example, the deeper the regular discharge, the shorter the lifetime of the battery, which has a warranty period of 15 years. To maximise economic benefits, the battery should be charged during low wholesale market price periods and discharged when the price is high, but these times are not easy to predict.

More research is needed into better battery scheduling algorithms that can predict the best charging and discharging times. This work, which is being undertaken at Monash Energy Materials and Systems Institute (MEMSI), is one way to deal with unreliable price forecasts, grid demand and renewable generation uncertainty.

The battery and the windfarm

Tesla's battery will be built next to the Hornsdale wind farm and will most likely be connected directly to AC transmission grid in parallel to the wind farm.

Its charging and discharging operation will be based on grid stabilisation requirements. This can happen in several ways. During times with high wind output but low demand, the surplus energy can be stored in the battery instead of overloading the grid or going to waste.

Conversely, at peak demand times with low wind output or a generator failure, stored energy could be dispatched into the grid to meet demand and prevent problems with voltage or frequency. Likewise, if the wind doesn't blow, the battery could be charged from the grid.

The battery and grid – will it save us?

In combination with SA's proposed gas station, the battery can help provide stability during extreme events such as a large generator failure or during more common occurrences, such as days with low wind output.

At this scale, it is unlikely to have a large impact on the average consumer power price in SA. But it might help reduce the incidence of very high prices during tight supply-demand periods, if managed optimally.

For instance, if a very hot day is forecast during summer, the battery can be fully charged in advance, and then discharged to the grid during that hot afternoon when air conditioning use is high, helping to meet demand and keep wholesale prices stable.

More importantly, the battery is likely to be the first of many such storage installations. As more renewables enter the grid, additional energy storage will be needed - otherwise the surplus energy will have to be curtailed to avoid network overloading.

Another storage technology to watch is off-river pumped hydro energy storage (PHES), which we are modelling at the Australia-Indonesia Energy Cluster.

The SA Tesla-Neoen announcement is just the beginning. It is the first step of a significant journey towards meeting the recommendation of zero emissions by at least 2050 by the Australian Climate Change Authority.

Source: The Conversation, 11 July 2017
https://theconversation.com/explainer-what-can-teslas-giant-south-australian-battery-achieve-80738

Major Australian bank found in breach of money-laundering laws

Editor

A recent ABC News report by Andrew Robertson [1] has revealed that CBA (the Commonwealth Bank of Australia) is facing potential fines of about a trillion dollars for nearly 54,000 breaches of Australia's money-laundering laws. The breaches date back to 2012.

This is about seven times the bank's current market value. If such massive fines come into effect then the bank will simply not be able to pay them and will become insolvent. If that happens then it will be of more than passing interest to see how the Federal Government will handle the crisis.

According to the money-laundering watchdog, AUSTRAC, "the effect of CommBank's conduct in this matter has exposed the Australian community to serious and ongoing financial crime" [1].

Banks are meant to be the watchdog for suspicious activity involving criminals and money. For example, in the current climate it's a key plank in the fight against terrorism.

The CBA was originally a public asset and was privatised by Paul Keating's Government on the grounds that the private sector could do a better job than the public sector. Many now realise that this expectation has not worked out as Keating envisaged. A range of financial scandals during the past two decades has resulted in recent calls for a Royal Commission into the banking system, and those calls are growing louder.

1. **Source:** ABC News, 3 August 2017
http://www.abc.net.au/news/2017-08-03/commonwealth-bank-latest-scandal-might-be-the-one-that-hurts/8772390

UK to ban petrol and diesel cars by 2040

Editor

Electric cars will soon be cheaper than petrol cars, creating turmoil for oil exporting countries

A recent article by Joe Romm [1] has drawn attention to the intention of the UK government to ban the sale of new petrol and diesel cars and vans by 2040, in order to reduce pollution and improve public health. A growing list of other countries have similar plans for phasing out cars which burn fossil fuels. And electric cars could be cheaper than petrol powered cars by 2025.

A major driving factor is the plummeting prices for electric batteries. “Electric cars will outsell fossil fuel-powered vehicles within two decades as battery prices plunge”, Bloomberg New Energy Finance (BNEF) forecasts, “turning the global auto industry upside down and signalling economic turmoil for oil-exporting countries”.

A stunning 73% fall in lithium-ion battery prices since 2010 is expected to be followed by an ongoing downward trend for at least two decades. The world is reaching peak oil demand faster than anyone expected, and the coming oil crash will be only the beginning.

1. **Source:** ThinkProgress, 27 July 2017
https://thinkprogress.org/uk-to-ban-gas-and-diesel-cars-7cc5e4982939

Dr Joe Romm is Editor of *Climate Progress*

Home ownership falling, debts rising – it's grim for the under 40s

Roger Wilkins

Declining home ownership among young people has implications for their long-term financial wellbeing and indeed for the retirement income system

Photo source: Flickr CC

Home ownership among young people is declining, as mortgage debt almost doubles for the same age group, results from the Household Income and Labour Dynamics in Australia (HILDA) survey show. It also shows young people are living with their parents longer.

The Melbourne Institute of Applied Economic and Social Research undertakes the survey every year, and it is Australia's only nationally representative household longitudinal study. It has followed the same individuals and households since 2001.

The survey has indicated that the rate of home ownership among 18 to 39 year olds declined from 36% in 2002 to 25% in 2014. In the same age group, the decline in home ownership has been largest for families with dependent children, falling from 56% to 39%.

Even for those within this group who manage to buy a home, mortgage debt has risen dramatically. In 2002, 89% of home owners in this age range had mortgage debt. By 2014 this had risen to 94%.

More significantly, the average home debt rose considerably. Expressed in December 2015 prices, average home debt grew from about A$169,000 in 2002 to about A$337,000 in 2014. Low interest rates since the global financial crisis have meant mortgage repayments for these home owners have remained manageable, but this group is very vulnerable to rate rises.

Detailed wealth data in the survey, collected every four years since 2002, show this increase in debt and decrease in ownership are part of a trend in the wider population. HILDA shows 65% of households were in owner-occupied dwellings in 2015,

down from 69% in 2001.

In fact, the decline in home ownership has been greater than the decline in owner-occupied households. This is largely because adult children are living with their parents for longer.

For example, the HILDA data show that the proportion of women aged 22 to 25 living with their parents rose from 28% in 2001 to 48% in 2015. For men this proportion rose from 42% to 60%.

Among those who manage to access the housing market, the data shows that the growth in home debt is not simply because they are borrowing more to purchase their home. A surprisingly high proportion of young home owners (30 - 40%) actually increase their debt from one year to the next, despite most of them remaining in the same home. Even over a four-year period - for example from 2010 to 2014 - at least 40% of young home mortgagees increase their nominal home debt.

The proportion of people with home debt that exceeds the value of their home – that is, negative equity – has also risen. In 2002, 2.4% of people had negative equity in their home; in 2014, 3.9% had negative equity. This is a relatively small proportion, but this could change as even small decreases in house prices will result in substantial increases in the prevalence of negative equity.

How this changes with location, income and profession

In 2014, less than 20% of Sydneysiders aged 18 to 39 were home owners, compared with 36% or more in the ACT, urban Northern Territory and non-urban regions of Australia. To a significant extent this reflects differences across regions in house prices. Sydney and Melbourne have particularly high house prices, while non-urban areas generally have comparatively low house prices. Regional differences in the incomes of 18 to 39 year olds also play a role.

Those with the highest home-ownership rates are professionals and, to a lesser extent, managers. They experienced relatively little decline in home ownership.

For workers in other occupations, home ownership has declined substantially. In 2014 home ownership was especially rare among community and personal services workers, sales workers and labourers.

This decline represents profound social change among this age group, where renting is increasingly becoming the dominant form of housing. In 2002, 61% of people aged 35 to 39 were home owners – a clear majority of their age group. By 2014, this proportion had fallen to 48%.

The changing housing situation of young adults is part of a broader change in the distribution of wealth in Australia. The HILDA Survey shows that differences in average wealth by age have grown since 2002. For example, in 2002, median net wealth of those aged 65 and over was 2.8 times that of people aged 25 to 34. In 2014, this ratio had increased to 4.5.

The decline in home ownership among young adults and this broader trend in wealth have implications for their long-term economic wellbeing and indeed for the retirement income system. Even if house price growth moderates and many of those currently aged under 40 ultimately enter the housing market, it’s likely that a rising proportion will not have paid off the mortgage by the time

they retire. It may be that many will resort to drawing on superannuation balances to repay home loans, in turn increasing demands on Age Pensions.

Source: The Conversation, 2 Aug 2017 https://theconversation.com/home-ownership-falling-debts-rising-its-looking-grim-for-the-under-40s-81619

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Australian housing affordability the worst in 130 years

Philip Soos and Lindsay David

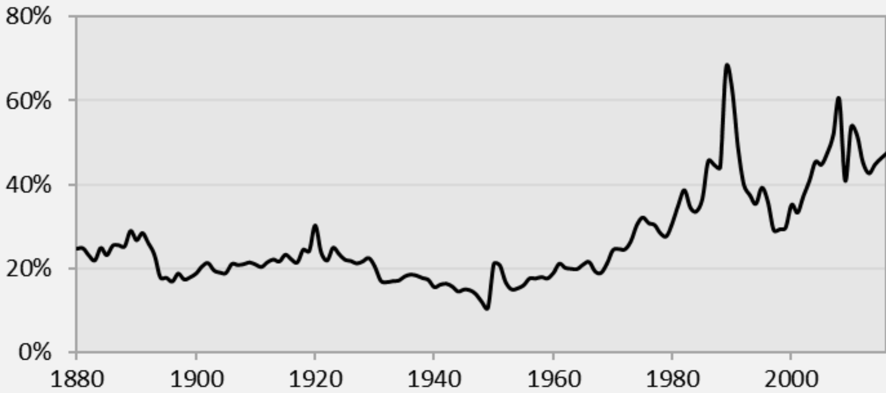
Economists and co-founders of LF Economics, Phillip Soos and Lindsay David, present compelling evidence that our economic system is eating the young alive.

The astronomical bubble in Australian housing prices has generated plenty of commentary regarding the current lack of affordability. This state of affairs clearly concerns aspiring home buyers everywhere, and those living in Sydney and Melbourne in particular.

First home buyers (FHBs) face almost insurmountable odds: the highest price to income and deposit to income ratios, the lowest savings rates, runaway dwelling prices, weak wage growth, including a political and economic establishment hell-bent on ensuring land prices keep on inflating no matter the wider cost to the economy.

The legion of vested interests – basically 99% of commentators – choose to contend that housing is actually more affordable today than back in the days of high mortgage interest rates, especially when rates peaked at 17% in 1989. This is demonstrated by the standard mortgage payment to household income formula shown below, assuming 80% loan to value ratio (LVR).

Their contention is bogus, however, because the metric is a static one, displaying mortgage payments to income at a particular point in time. The peak in 1989, for instance, is very high if, and only if, prices, interest rates and



incomes remain constant over the life of the mortgage. However these variables change by the next period. So, a more dynamic approach is required to assess housing affordability.

The correct method was advocated by Glenn Stevens in 1997, by Guy Debelle in 2004 and other economists like Dean Baker, who identified the U.S. housing bubble and predicted the GFC (Global Financial Crisis) in 2002. The important factor to consider is the effect wage inflation has upon mortgage payments.

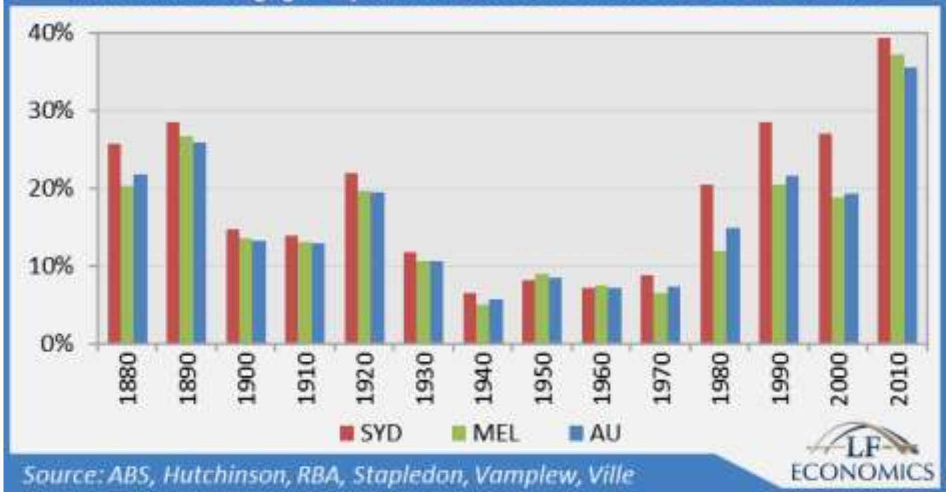
While high mortgage interest rates result in large mortgage payments relative to income, this only occurs in the early years of the mortgage as high wage growth inflates away the burden. In contrast, borrowers facing high housing prices with low interest rates and poor wage growth face a greater burden across the life of the mortgage due to greater payments to income.

This housing affordability analysis is applied to long-term annual data between 1880 and 2016, anchored to the median house price at an LVR of 80% at the start of each decade thereon. While data on mortgage interest rates and wage growth for the years after 2016 cannot be known, they are assumed to hold still at the present rates: 5.4% for the mortgage interest rate and 1.4% for wages.

The chart below illustrates the outcome of applying this method, demonstrating the proportion of aggregate mortgage payments to household income over the 25 years of the mortgage. The results are overpowering.

Affordability was strained during the 1890s for a long time, primarily due to the decline of household income which stemmed from the collapse in nominal wages during the worst economic depression on record. The persistently high unemployment rate prevented a recovery in wage growth throughout this decade.

The best period for house purchase was between the 1940s and 1970s: regulated social democratic capitalism. These decades were demarked by low



housing prices and mortgage interest rates, and high nominal wage growth. The extreme wage explosions in the early 1950s and mid-1970s significantly assisted borrowers by inflating away mortgage payments.

From the 1980s onward, conditions became more difficult as wage growth declined, interest rates rose and housing prices increased. While the single worst year for purchase would've been in 1989, buyers benefitted from declining interest rates and the eventual recovery in wage growth, including the escalation in housing prices from 1996 onward.

The year 2010 stands out above all else. Extreme housing prices combined with the lowest nominal wage growth post-WW2 means mega mortgage mugs will not have their loan payments inflated away, despite lower interest rates than in the decades between 1980 and 2000. The stats for 2017 will be shocking.

There are three ways to assist affordability: declining interest rates, rising wage growth and falling housing prices. Presently, the only pathway to improved affordability is the latter option. This is obviously opposed by political parties, the FIRE (finance, insurance and real estate) sector and economists employed by these vested interests.

Trends are ominous for recent and aspiring buyers. Nominal wage growth will continue to decline as economic growth limps along, no productivity-enhancing policies have been enacted in recent times, underemployment continues to rise, the terms of trade will weaken over the long-term and excessive immigration floods an already weak labour market.

Nominal rental price growth is currently the weakest since the early 1990s recession, which was the worst economic downturn in post-WW2 history. In some cities such as Perth and Darwin, rents are plummeting. The largest cities, Sydney and Melbourne, are experiencing tepid rental price growth as population inflows mount.

The Treasurer, Scott Morrison, stated

that low wage growth was the biggest challenge facing the economy, yet hypocritically continued to attack wages, workers and unions. Worse, given the likelihood of recession over the next 25 years, possibly even GFC 2.0 with a Chinese economic downturn, nominal wage growth could turn negative for the first time since the Great Depression.

Additionally, there are a variety of upwards pressures causing mortgage interest rates to rise, independent of the policy rate. With interest rates and bond yields reflating in some developed countries, Australian banks cannot avoid paying more to fund their operations or they will find it increasingly difficult to raise wholesale funds from international markets.

APRA's second round of macroprudential controls are giving the banks the excuse to raise rates on interest-only loans, pushing more borrowers to convert to principal and interest mortgages. Both measures produce higher mortgage payments relative to income.

With household balance sheets squeezed on all sides, servicing mortgages will become increasingly challenging. Indeed, it is difficult to see from where high wage and rental price growth will eventuate, and it is highly unlikely that mortgage interest rates can be further reduced significantly.

So where does this leave those young people looking to buy? Simply put, they are up a certain creek without a paddle. With the economy thoroughly anchored to continued growth of private debt, policymakers cannot allow housing prices to fall by any significant measure for the benefit of new buyers.

Source: Renegade Inc., July 2017. Reproduced with permission of the authors. Published originally by Renegade Inc. which is dedicated to everything we got wrong about the economy, business, tech, arts, culture.

Philip Soos is co-founder of LF Economics, co-author of *Bubble Economics* and an economics PhD candidate investigating Australian bank and mortgage control fraud.

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China's Belt and Road initiative

Editor

The following information about China's Belt and Road initiative was extracted from articles by Peter Cai [1,2]:

" China's Belt and Road Initiative - also known as One Belt One Road (OBOR) - is one of President Xi's most ambitious foreign and economic policies. It aims to strengthen China's economic leadership through a vast program of infrastructure building throughout China's neighbouring regions. Many foreign policy analysts view this initiative largely through a geopolitical lens, seeing it as China's attempt to gain political leverage over its neighbours. This is undoubtedly part of Beijing's strategic calculation. However, this analysis argues that some of the key drivers behind OBOR are largely motivated by China's pressing economic concerns.

" One of the overriding objectives of OBOR is to address China's deepening regional disparity as the country's economy modernises. Beijing hopes its transnational infrastructure building program will spur growth in China's underdeveloped hinterland and rustbelt. The initiative will have a heavy domestic focus. The Chinese Government also wants to use OBOR as a platform to

There have been open forums on greening the OBOR Initiative in November 2015 and August 2016 held as part of the Annual General Meeting of the China Council for International Cooperation on Environment and Development. In his 2015 presentation, Director General Li Yong stressed the need for policy support to the participating countries of the One Belt One Road Initiative to ensure a functional and effective institutional and regulatory framework. He also highlighted the need to minimize environmental impacts, to establish appropriate environmental policies and to strengthen the capacities for effective environmental policy planning and implementation. Photo source: Flickr CC

address the country's chronic excess capacity. It is more about migrating surplus factories than dumping excess products. One of the least understood aspects of OBOR is Beijing's desire to use this initiative to export China's technological and engineering standards. Chinese policymakers see it as crucial to upgrading the country's industry. "

".. OBOR is arguably one of the largest development plans in modern history. On land, Beijing aims to connect the country's underdeveloped hinterland to Europe through Central Asia. This route has been dubbed the Silk Road Economic Belt. The second leg of Xi's plan is to build a 21st Century Maritime Silk Road connecting the fast-growing South-east Asian region to China's southern provinces through ports and railways.

" All levels of the Chinese Government, from the national economic planning agency to provincial universities, are scrambling to get involved in OBOR. Nearly every province in China has developed its own OBOR plan to complement the national blueprint. State-owned policy and commercial banks have announced generous funding plans to fulfil President Xi's ambitious vision.

" Xi has launched OBOR at a time when Chinese foreign policy has become more assertive. This has meant that OBOR is often interpreted as a geo-

political plan rather than a purely economic one. While there is a great deal of truth to this interpretation, this analysis argues that focusing on the geopolitical dimensions of OBOR obscures its principally geoeconomic drivers, in particular its connection to changes in China's domestic industrial policy.

".. there are many more concrete and economic objectives behind OBOR that should not be obscured by a focus on strategy. The most achievable of OBOR's goals will be its contribution to upgrading China's manufacturing capabilities. Given Beijing's ability to finance projects and its leverage over recipients of these loans, Chinese-made high-end industrial goods such as high-speed rail, power generation equipment, and telecommunications equipment are likely to be used widely in OBOR countries. More questionable, however, is whether China's neighbours will be willing to absorb its excess industrial capacity. The lack of political trust between China and some OBOR countries, as well as instability and security threats in others, are considerable obstacles.

" Chinese bankers will likely play a key role in determining the success of OBOR. Though they have expressed their public support for President Xi's grand vision, some have urged caution both publicly and in private. Their appetite to fund projects and ability to handle the complex investment environment beyond China's border will shape the speed and the scale of OBOR. There is a general recognition that this initiative will be a decade-long undertaking and many are treading carefully."

Sources:

1. http://acyd.org.au/acyd/understanding-chinas-belt-and-road-initiative
2. https://www.lowyinstitute.org/publications/understanding-belt-and-road-initiative

Peter Cai is a Nonresident Fellow at the Lowy Institute for International Policy. Previously he was a journalist with The Australian, Business Spectator, The Age and Sydney Morning Herald, covering business and economic news. Prior to becoming a journalist, Peter was at the Australian Treasury where he worked in the Foreign Investment Review Board Secretariat, focusing largely on state-owned enterprises and sovereign wealth fund investment policy. Peter has degrees from Oxford University and Adelaide University.

Australia's interest in China's One Belt One Road

Alice de Jonge

An article by Alice de Jonge published in The Conversation on 16 May 2017 entitled "Australia risks missing out on China's One Belt One Road" [1] *stated that Australia is late to the party in only recently expressing interest in China's OBOR initiative, and that if Australian businesses don't take advantage of the opportunities available in this project now then there are plenty of regional competitors that will take their place. According to this author:*

Australia became an unofficial OBOR partner in 2016, with the launching of the Australia-China OBOR Initiative (ACOBORI), a public-private NGO [2]. This occurred less than one year after the signing of the China-Australia Free Trade Agreement.

Australia has so far declined China's offer to formally link the Northern Australia Project to OBOR. However, more recently the Trade Minister Steve Ciobo said that he sees merit and opportunities for collaboration (particularly in regard to the Northern Australia initiat-

ive) arising from OBOR, adding the caveat that decisions about such collaborations would be taken 'on the basis of what is Australia's national interest'.

Following the old silk road

China's OBOR initiative comprises a land belt and a sea road. The land belt connects China's underdeveloped hinterland to Europe, traversing 65 countries across the land terrain of the ancient Silk Road land route. The sea leg comprises a network of railways and ports crossing an ocean route that connects Europe with the Middle East, Africa and Southeast Asia.

OBOR has significant backing in China, including from the China-led Asia-Infrastructure Investment Bank (AIIB).

OBOR is backed not just by the AIIB, but also by two other recent development finance initiatives - the Silk Road Infrastructure Fund and the New Development Bank. The infrastructure fund, made up of Chinese foreign exchange reserves, will act like a Chinese sovereign wealth fund. The bank was established in 2014 by BRICS nations (Brazil, Russia, India, China and South Africa).

For the government, OBOR provides a policy tool for channelling investment from China's wealthy seaboard provinces to the under-developed central and western regions. It channels China's investment into projects that will have longer-term benefits, and not just into assets that are vehicles for parking hot money. All at a time when China is seeking to curb the flight of money from the country.

Australian business involvement

There are many risks and challenges to be faced in such a vast initiative as OBOR - with its cross-border projects involving a variety of different countries, each with its own historical baggage and current preoccupations.

An inaugural ACOBORI report identified a number of established and emerging sectors of opportunity for Australian industry arising from OBOR. Both inbound and outbound trade and investment with China can, importantly, pave the way for greater diversification of the Australian economy.

The University of Melbourne affiliate, Asialink, identifies opportunities in sectors such as: agriculture, financial and legal services, education, tourism, healthcare, energy, architecture engineering and planning expertise.

The Australian services sector has so far demonstrated the keenest interest in OBOR, especially in finance and law. The list of those already involved include three of the big four banks, law firms King Wood and Mallesons and Minter Ellison, and global engineering consulting firms Worley Parsons, SMEC and Norman Disney & Young.

It's the smaller firms and those in challenged sectors (particularly manufacturing) that appear less willing to investigate the risks and opportunities. This isn't helped by the Australian government, which appears to be torn between a fear of Chinese influence and a desire not to miss out on potential opportunities for lucrative involvement in OBOR projects.

Australian business involvement

There are two key reasons why Australia needs to remain involved in both the AIIB and OBOR. The first is the risk of missing out if Australian businesses don't take advantage of the opportunities available.
Foreign firms are already taking advantage of the situation. For example, Hutchinson Ports, controlled

by CK Hutchison Holdings of Hong Kong's Li Kashing, already operates ports at 22 locations in 18 countries along the OBOR route. Hutchinson Ports is planning to start operations in another three countries along the route in 2017, and enlarge capacities of existing terminal facilities to ride on growing demand.

At the moment researchers describe the situation surrounding China's OBOR as "contested multilateralism". This is where states and businesses use new multilateral institutions to challenge established institutions, rules, practises or missions.

The AIIB has been seen as a challenge to the established institutions of the (US-dominated) World Bank and the (Japan-dominated) Asian Development Bank. China's OBOR initiative can similarly be seen as a challenge to the dominance of US and European investment presence in the region.

In such a world, clever businesses are not seeing any need to choose sides. So far as possible, they are playing the field; taking advantage of opportunities as they arise, all the while keeping careful track of changing risks.

The second reason why Australian businesses need to remain actively engaged, is to ensure that the country is in a position to influence the longer-term future of the region. Australia should be using its influence in order to emphasise the potential for the OBOR initiatives to help achieve sustainable development goals including reducing hunger, poverty and inequality - to name a few.

1. The Conversation, 16 May 2017 https://theconversation.com/australia-risks-missing-out-on-chinas-one-belt-one-road-77704

2. http://www.australiachinaobor.org.au/

Alice de Jonge is a senior lecturer in International Law, specialising in Asian Business Law, at Monash University.

Warren Buffet on derivatives

Editor

The following are edited excerpts from the Berkshire Hathaway annual report for 2002, written by Warren Buffet. We are grateful to William Hummel for drawing our attention to this material.

Basically derivatives call for money to change hands at some future date, with the amount to be determined by one or more reference items, such as interest rates, stock prices, or currency values. For example, if you are either long or short an S&P 500 futures contract, you are a party to a very simple derivatives transaction, with your gain or loss derived from movements in the index.

Derivatives contracts are of varying duration, some running for years, and their value is often tied to several variables.

Unless derivatives contracts are collateralized or guaranteed, their

ultimate value also depends on the creditworthiness of the counter-parties to them. But before a contract is settled, the counter-parties record profits and losses – often huge in amount – in their current earnings statements without so much as a penny changing hands. Reported earnings on derivatives are often wildly overstated. That's because today's earnings are in a significant way based on estimates whose inaccuracy may not be exposed for many years.

The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity very clear. Central banks and governments have so far found no effective way to control or even monitor the risks posed by these contracts. In my view, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.

Web references:

1. http://www.fintools.com/docs/Warren%20Buffet%20on%20Derivatives.pdf
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Krugman and Mankiw on loanable funds — so wrong

Lars Syll

A couple of years ago - in a debate with James Galbraith and Willem Buiter - Paul Krugman (a winner of the Swedish National Bank's Prize in Economic Sciences) made it perfectly clear that he strongly believes in the 'loanable funds' theory. Unfortunately, this is not an exception among 'New Keynesian' economists.

Neglecting anything resembling a real-world finance system, Greg Mankiw -- in his intermediate textbook *Macroeconomics* -- more or less equates finance to the neoclassical thought-construction of a 'market for loanable funds.' On the subject of financial crises, he admits:

" perhaps we should view speculative excess and its ramifications as an inherent feature of market economies … but preventing them entirely may be too much to ask given our current knowledge. "

This is also self-evident for all of us who understand that genuine uncertainty makes any such hopes totally unfounded. But it's rather odd to read this in a book that bases its models on assumptions of rational expectations, representative actors and dynamically stochastic general equilibrium – assumptions that convey the view that markets – give or take a few rigidities and menu costs – are efficient! For being one of many neoclassical economists so proud of their consistent models, Mankiw here certainly is flagrantly inconsistent!

And as if being afraid that all the talk of financial crises might weaken the student's faith in the financial system, Mankiw, in his concluding remarks, has to add a more Panglossian warning that we

" should not lose sight of the great benefits that the system brings … By bringing together those who want to save and those who want to invest, the financial system promotes economic growth and overall prosperity "

Really? Finance has its own dimension, and if taken seriously, its effect on an analysis must modify the whole theoretical system and not just be added as an unsystematic appendage. Finance is fundamental to our understanding of modern economies, and acting like the baker's apprentice who, having forgotten to add yeast to the dough, throws it into the oven afterwards, simply isn't enough.

I may be too bold, but I'm willing to take the risk, and so recommend Krugman and Mankiw to make the following addition to their reading lists: **William Vickrey - *"Fifteen Fatal Fallacies of Financial Fundamentalism"*.** From this source we find:

" **Fallacy 2**

Urging or providing incentives for individuals to try to save more is said to stimulate investment and economic growth.

Saving does not create "loanable funds" out of thin air. There is no presumption that the additional bank balance of the saver will increase the ability of his bank to extend credit by more than the credit supplying ability of the vendor's bank will be reduced. If anything, the vendor is more likely to be active in equities markets or to use credit enhanced by the sale to invest in his business, than a saver responding to inducements such as IRA's, exemption or deferral of taxes on pension fund accruals, and the like, so that the net effect of the saving inducement is to reduce the overall extension of bank loans. Attempted saving, with corresponding reduction in spending, does nothing to enhance the willingness of banks and other lenders to finance adequately promising investment projects. With unemployed resources available, saving is neither a prerequisite nor a stimulus to, but a consequence of capital formation, as the income generated by capital formation provides a source of additional savings. "

" **Fallacy 3**

Government borrowing is supposed to "crowd out" private investment.

On the contrary, the current reality is that the expenditure of the borrowed funds (unlike the expenditure of tax revenues) will generate added disposable income, enhance the demand for the products of private industry, and make private investment more profitable. As long as there are plenty of idle resources lying around, and monetary authorities behave sensibly, (instead of trying to counter the supposedly inflationary effect of the deficit) those with a prospect for profitable investment can be enabled to obtain financing. Under these circumstances, each additional dollar of deficit will in the medium long run generate two or more additional dollars of private investment. The capital so created is an increment to someone's wealth and ipso facto someone's saving. "Supply creates its own demand" fails as soon as some of the income generated by the supply is saved, but investment does create its own saving, and more. Any crowding out that may occur is the result, not of underlying economic reality, but of inappropriate restrictive reactions on the part of a monetary authority in response to the deficit. "

Source Real World Econ Rev, 18 Aug 2017

William S Vickrey was a Canadian-born economist, and winner of the Bank of Sweden Prize in Economic Sciences (with James Mirrlees) for their research on incentives under asymmetric information.

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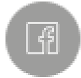

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