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The paradigm shift in economic policy

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The extraordinary events in world financial markets which have undermined the basis of capitalism have led to equally amazing Government responses – massive injections of public spending, nationalisations of banks and bailouts of huge financial institutions with little regard for the relevant shareholder interests.

A major paradigm shift is occurring in economic thinking away from the free market deregulation era that has dominated since the 1970s.

All the logic that justified government cut backs; the run down of public infrastructure; the harsh treatment of welfare recipients; the wasteful privatisations, and the rest of the neo-liberal litany that served to transfer wealth from poor to rich and create an disadvantaged underclass has been destroyed by these events.

We now know that the free market does not work effectively.

We learned this lesson during the Great Depression but then, in recent times, forgot that markets need strong regulation and that the Government has to play a strong role as an employer and a spender. The policy folly of the last few decades which has culminated in this disaster shows that governments need to firmly steer the ship.

Tuesday's announcement by Prime Minister Rudd reflects this shift and is generally sound.

The fiscal policy (spending and taxation) stimulus amounts to about 1 per cent of GDP which suggests the Government was forecasting a substantial decline in economic growth should no intervention occur.

The neo-liberal response to the crisis was to rely on monetary policy (lowering interest rates; changing conditions under which central banks will lend to private banks etc). This strategy failed because they didn't understand the problem.

There is plenty of liquidity in the banking system. Missing is the confidence to make it available. Lowering the price of credit does not tell prospective borrowers that they will be able to sell what they produce.

The advantage of fiscal policy is that it directly stimulates spending and signals to firms an increasing demand for their goods and services. It instils confidence that economic growth will continue.

PM Rudd's announcement is all about increasing confidence. It will provide money to those who are likely to spend it quickly and within Australia. The \$10 billion injection recognises that fiscal policy alone can directly stop a spending collapse.

The stimulus is well targetted. Pensioners and low income earners do not save much. These citizens have been severely squeezed by rising interest rates and rising petrol prices. The relief will be spent immediately.

Sensibly, the one-off payments give immediate relief but also allow the Government to finish their review of pensions before changing rates. One expects significant rate increases will occur in next year's budget.

The Hunter will receive significant benefits from this package. The 2006 Census data shows that 15.8 per cent of Newcastle residents were above 65 years of age compared to 13.3 per cent nationally. Also, median weekly household income in Newcastle was \$885 compared to \$1027 nationally.

The housing stimulus while reflecting the importance of the construction industry to the economy is questionable. A better targetted low-income housing plan would be better than to provide non-means tested handouts to home buyers. The subsidy for existing dwellings may also just drive up prices.

More public job creation is also needed. If the government can guarantee bank deposits then they should introduce a job guarantee to assist the unemployed.

Disturbingly, the Government still doesn't fully understand the way ahead. They are wrong to say that the past 11 years of budget surpluses have given them this capacity to spend. The Government can spend whenever it wants to irrespective of last year's budget position.

Further, running surpluses has been bad for the economy because it undermines the private sector's ability to save. With the surplus ripping off private liquidity, households and businesses can only enjoy spending growth by increasingly going into debt. This debt binge is one of the principal causes of the current financial crisis.

Government has to re-learn that deficits are normal and provide the liquidity to finance private savings and ensure that spending in the economy generates full employment.

But the stimulus is a step in the right direction. It will help avert a rise in unemployment and help citizens who missed the neo-liberal wealth binge receive a better share of the pie. It will also stop the strutting arrogance of the free market lobby who should now hang their heads in collective shame for the damage their uninformed policies have caused.