AUSTRALIAN PUBLIC POLICY

TITLE:

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Working Paper: P07_3

2007

RSMG Working Paper Series

Schools of Economics and Political Science

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St Lucia

Brisbane

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Web: www.uq.edu.au

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We thank Nancy Wallace for helpful comments and criticism.
This research was supported by an Australian Research Council Federation Fellowship.

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The pattern of boom and bust that characterised the Australian economy from the early 1970s to the early 1990s currently seem to be a thing of the past as Australia enters its sixteenth year of uninterrupted expansion. The expansion has lasted twice as long as those of the 1970s and 1980s, which raises the question — why has it happened?

Given the space constraints of this paper, one way of simplifying our approach to this question is to identify the major factors that previously precipitated major slumps or recessions. The major recessions of the mid 1970s, the early 1980s and the early 1990s, were induced by monetary policy and a determination by of the Treasury and Reserve Bank to slow an overheated economy. The first two policy-induced recessions were aimed primarily at fighting inflation. The recession of the early 1990s was a product of policy attempts to slow the economy in the face of a perceived current account crisis and domestic financial overheating, particularly the credit-fuelled asset price inflation of the late 1980s.

The expansion that began in the early 1990s has also been characterized by large current account deficits and strong asset price inflation, particularly in the period since 2000. However, the policy response has not been sufficiently restrictive to generate a recession or even a significant slowdown in rates of economic growth. This is partly the result of greater confidence on the part of the Reserve Bank that the threat of inflation is under control and partly the result of a broader change of thinking about current account imbalances, which developed in response to the perceived policy errors of the early 1990s.

On the current, 'consenting adults' view, current account imbalances are viewed as market outcomes which will only be problematic if prudential regulation is inadequate. Thus, the current account is no longer a target of monetary policy. The question of whether large current account imbalances will eventually generate increased vulnerability to adverse shocks, or whether the growing volume and sophistication of capital markets has rendered such concerns obsolete is central in addressing the sustainability of the current expansion.

It may also be argued that the Reserve Bank has been more skilful, or luckier, in the present cycle than it was in the past and also that it has made better judgements than other central banks facing similar fundamentals such as the Reserve Bank of New Zealand. This argument obviously raises the question of whether such superior performance can be sustained.

In this necessarily brief paper, we will discuss some of the issues regarding the contribution of changes in monetary policy to the longevity of the current boom, and their implications for the sustainability of continued expansion. We begin with an overview of monetary policy and its relation to inflation since 1970. Next we discuss changing views of the current account and their implications. Finally, some concluding comments are offered.

Inflation, Financial Overheating and Monetary Policy

Figure 1 charts CPI inflation against short-term interest rates since 1970 and indicates that periods of high inflation in Australia have often been associated with the imposition of high short term interest rates.

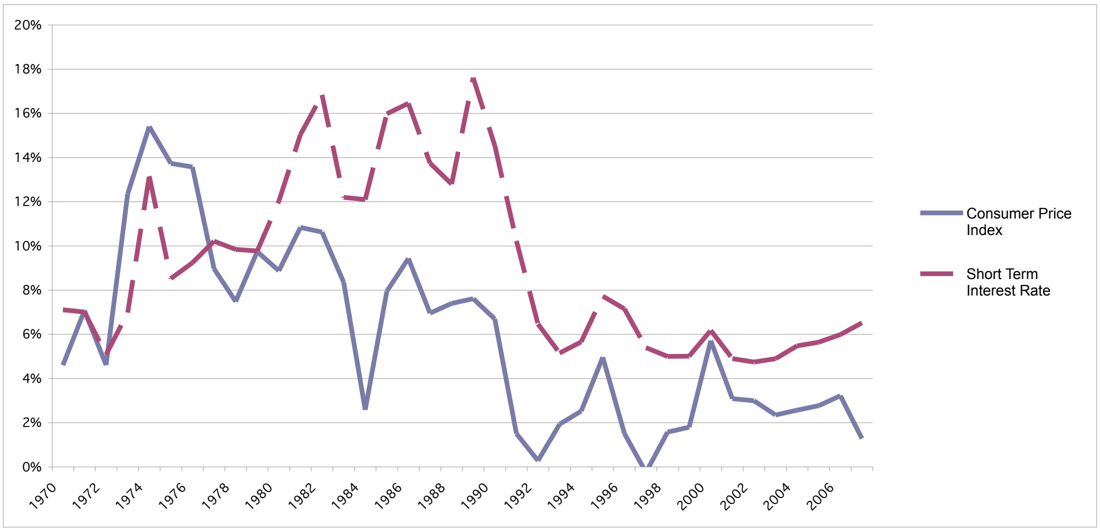


Figure 1

Inflation and short term interest rates, 1970-2007.

This pattern is particularly clear during the 1974-5 recession and again in the early 1980s recession. The relationship breaks down somewhat during the remainder of the 1980s because the interest rate spikes of 1986 and 1989 both occurred amidst only modest increases in headline inflation and amidst more or less persistent falls in underlying inflation. As argued below, the high interest rate response of the late 1980s was primarily intended to fight other problems, such as domestic financial overheating and current account problems.

Australia's inflation problem, especially during the 1970s and early 1980s, was largely driven by pressures from labor markets. As Kalecki (1943) had predicted, the full employment of the post-war 'golden age' had greatly strengthened labor's position in distributional conflicts over wages and profits. When growth slowed in the 1970s the struggle intensified to produce stagflation, manifested as rising wages despite recession. The recessions of the 1970s and the early 1980s saw large spikes in labour's share of national income (Bell 1997: 92–93).

The centralised arbitration and wage fixing system meant that wage increases typically emanating from the manufacturing sector would spill across the economy. This effect was further promoted by tariff protection, which meant that the manufacturing sector could typically pass on costs to consumers and other sectors. This combination of labour empowering economic conditions at the tail end of the post-war boom helped fuel the intense distributional struggles of the 1970s and early 1980s.

Despite securing wage increases, labour interests increasingly became disillusioned with this kind of raw distributional struggle. The early 1980s recession did not erode the pay increases associated with the 'resources boom' that preceded it, but over one hundred thousand jobs were lost in manufacturing alone. The unions decided to co-operate with the Labor governments of the 1980s to forge a new approach based on corporatist wage moderation institutionalised within the post-1983 Prices and Incomes Accords (Stilwell 1986). The resulting wage moderation contributed a significant overall fall in underlying inflation during the 1980s. Accordingly, Bob Johnston, the Governor of the Reserve Bank during the 1980s, commented that, 'it did not seem practical to single out price stability as *the* focus of monetary policy' (Bell 2004: 54, original emphasis).

A number of things happened to change this trajectory; change which wrecked the expansionary momentum of Labor's Accord and eventually saw inflation return as *the* focus of policy. The first problem was that the monetary authorities handled the process of post-1983 financial deregulation badly. Credit liberalisation and slack prudential supervision helped produce a major credit explosion and an asset price boom by the decade's end, especially in property. This overheating was accompanied by a more generalized boom which saw the current account deficit rise to levels widely seen as unsustainable. The current account, rather than inflation, became the immediate target of policy. The second problem was that the authorities badly miscalculated their policy response to the boom.

The details of Australia's first major experience of a post-deregulation asset boom (and subsequent bust) are sufficiently well known not to need recounting here (Bell 2004: 47–50). But the second problem above – the policy misreading and blundering into a recession – warrants brief attention. There were errors in forecasting. The scale of the boom and subsequent crash were not foreseen.

Policy confidence in avoiding a recession was boosted by the fact that the peak level of interest rates at the end of 1989 was lower than during the previous steep tightening in 1985 and lower than those that precipitated a recession in the early 1980s. Also, the share market crash of 1987 appeared to indicate that an asset price bubble could burst without doing much damage to the real economy. There was also the false impression generated by the experience of 1985–86; that the use of very high interest rates that peaked in late 1985 could be followed by a soft landing. Given subsequent events, this was a fundamental misreading. Nor was there sufficient recognition that the boom of the late 1980s was largely driven by a new form of asset inflation in property markets.

Nobody knew exactly what the effects of high interest rates would be in a deregulated, credit saturated financial system. As the RBA now puts it, there was an ongoing 'calibration' problem with the interest rate weapon. Some insiders have also claimed that the policy making procedure at the time was too myopic and that there was a tendency to look backwards at existing data for guidance on the effects of policy that were not likely to impact on the economy for as much as a year ahead.

Prior to the recession the Governor of the Reserve Bank, Bernie Fraser, had quipped that: 'People generally feel that inflation is bad, but… not so bad that they want the authorities to get too serious about eliminating it' (Fraser 1990: 20). The journalist, Michael Stutchbury (1989), called this Fraser's 'mission impossible'. But once the monetary authorities and the government had blundered into the recession, it became apparent to the RBA and the Treasury, that a new and perhaps successful final assault on inflation might be something that could be salvaged from the wreckage. As the RBA's former Deputy Governor, Stephen Grenville, has commented, the 'mindset' changed within the Bank.

The rapidly improvised policy response was to hold up rates for longer to help achieve the new goal. Probably the frankest admission of this has come from the then Deputy Governor, Ian Macfarlane:

> It may have been possible to have a somewhat smaller recession if all the policy guns had been quickly turned towards maximum expansionary impact. But if we had followed this course how could people credibly have believed we were serious about reducing inflation? …The central point is that on this occasion we had to run monetary policy somewhat tighter than in earlier recessions and take the risk that the fall in output would be greater… (Bell 2004: 71).

Given the depth and length of the recession in the early 1990s, inflation fell rapidly, and expectations about inflation followed suit. This episode broke the back of inflation and since the recession the CPI inflation rate has been low and relatively steady. By 1993 the RBA was feeling confident enough about inflation to devise its own inflation targeting system. During the ensuring economic boom inflation has remained near the centre of the RBA's target range, averaging around 2.6 per cent. The current (2007) inflation rate is no higher than at the start of the boom, although inflationary pressures have been building recently.

Why have Australia's inflation outcomes changed so much? First, the labour market has changed. Prolonged unemployment from the 1970s to the aftermath of the early 1990s recession helped 'discipline' labour. The recession saw unemployment rise from around 430,000 to over a million. Moreover, the subsequent employment recovery was slow. Second, such disciplinary measures have been paralleled by structural change in the economy which has seen the rapid growth of non unionized service sector employment and employment declines in traditionally unionized manufacturing sectors. This has helped reduce union density and also rendered many forms of employment less secure; again acting as a discipline. Third, in the wake of the recession, the industrial relations system was fundamentally changed by Labor's introduction of enterprise bargaining. This placed more power in the hands of employers, further disciplined labour and assisted in limiting the economy wide impacts of pay increases in particular sectors.

The result of both of these sets of changes meant that the post recession expansion did not see a return of rapid wages growth of the kind that had previously fuelled inflation. This was probably *the* major turn around. Over the fourteen years to the middle of 2005, labour costs increased only 27 per cent, compared to 144 per cent over the fourteen years prior to this (Edwards 2006: 72). Fourth, the unwillingness of employers to countenance large wage rises was also reinforced by another major change in the long standing 'Australian settlement' policy framework; the shift towards tariff reform and lower protection. The tariff reductions, which had been underway since the 1970s, with additional reductions in the late 1980s and early 1990s, dramatically increased competitive pressure on exposed business sectors and made them both less willing and able to pass on cost increases into prices, as had traditionally been the case

Finally, in the wake of the bruising recession and growing anti-inflation credentials of the RBA, all players became increasingly aware of the potential costs of a renewed round of inflation. The Bank would act decisively if needed to curb it. The first significant post recession test for the RBA came in 1994 as inflationary pressures rose and rates were tightened pre-emptively in three steps by 275 basis points over five months. Growth slowed briefly but inflation was checked and the economy continued on an expansionary path. The RBA's growing credibility in the markets was illustrated by the fact that, by 1996, the yield on Australian government bonds had dropped below that of New Zealand's for the first time in over a decade; indicating that investors considered Australia's prospects for low inflation superior to the once lauded New Zealand model (Macfarlane 2006: 87).

As outlined above, part of this new stability was derived from the fact that the RBA was now dealing with an economy less prone to inflation. In this context, the RBA's key strategy has been to develop a *flexible* inflation targeting regime involving a 2–3 per cent inflation target, to be achieved *on average* over a run of years. In practice, this target is implemented through a 'Taylor rule' in which both the rate of inflation and the rate of economic growth are targeted, with the underlying assumption being that deviations of either variable from target values are both undesirable and unsustainable.

Critics claimed the framework was too vague and flexible. As the RBA's former Governor, Ian Macfarlane commented: 'people said that this was a sign of weakness. So ours was definitely regarded — of the half dozen models then available — as being the softest of the spectrum'. (Bell 2004: 83) Critics also pointed out that the RBA's target was on the high side and praised the more hawkish 0–2 per cent inflation targets that had been established in New Zealand and Canada. But as Macfarlane (1998: 13) noted: 'We regarded this as probably too low, and certainly too narrow a range. No country had achieved this sort of inflation performance over any significant time interval in the past 50 years'. Bernie Fraser observed that, 'The target was seen as weak by those that favoured the New Zealand benchmark; we chose very deliberately *not* to adopt such a benchmark' (Bell 2004: 81–86).

Emblematic of the Bank's cautious post-recession approach was the response to the Asian financial crisis in 1997–1998. During the crisis, market concerns about the potential fallout in Australia, particularly with respect to exports, were reflected in a depreciating currency. The Bank could have attempted to defend the currency, ward off any potential imported inflation, and appease market concerns by adopting higher interest rates, but it chose not to. The floating rate regime provided an effective buffer. The Reserve Bank allowed the Australia–US exchange rate to depreciate to 50 cents, in line with the depreciation of Asian currencies. As a result, demand for Australian exports remained relatively strong. Along with a shift to more expansionary fiscal policy, partially reversing the Budget cuts of 1996, the result was that Australia was almost entirely unaffected by the crisis, earning the label 'miracle economy' from Paul Krugman (1998).

Under the fixed-rate regime the Bank would have been forced to defend the currency, with a domestic recession as the likely result. The net effect of the Bank's response was to cushion the impact on the domestic economy and to absorb the shock on the exchange rate. Crucially, interest rates were not raised and domestic growth and employment were protected. John Edward of HSBC, comments that Macfarlane did well: 'A more easily rattled Governor, someone with less monetary experience, someone with more reliance on models and theories and less on accumulated wisdom, would quite easily have cost Australia billions of dollars in lost output and a hundred thousand jobs' (quoted in Burrell 1999). The contrast with the more hawkish stance adopted in New Zealand and Canada is instructive. The central banks in both countries chose a more orthodox approach. They raised interest rates, tried to support the currency and landed in a policy-induced recession.

Changes in the Bank's approach to monetary policy also appear to have contributed to a decoupling of the Australian and US macroeconomies. For reasons that are not entirely clear, the US and Australian economies moved together fairly closely in the 1970s and 1980s. However, Australia was unaffected by the (admittedly relatively mild) US recession of 2001-02, and thus far appears unaffected by the US recession (or perhaps slowdown) that began in late 2007.

Table 1 shows data on economic growth, inflation and interest rates across a range of leading economies for the 1980s and 1990s.

Table 1 Comparative GDP, Inflation, and Interest Rates for selected OECD countries, 1980s/1990–2003

	Average GDP Growth (%)			Average Inflation (%)			Average Interest Rates (%)		
	1980's	1990–2003	Change	1980's	1990–2003	Change	1980's	1990–2003	Change
Australia	3.3	3.6	0.3	7.9	2.2	-5.7	15.2	6.4	-8.8
New Zealand	2.5	2.8	0.3	10.8	2.0	-8.8	17.3	7.4	-9.9
Japan	4.6	1.7	-2.8	2.1	0.8	-1.2	6.1	2.1	-4.1
Canada	2.8	2.7	-0.1	6.0	2.0	-4.0	11.2	5.7	-5.5
USA	3.0	3.0	0.0	4.7	2.8	-1.9	9.9	5.2	-4.7
Germany	1.8	2.2	0.4	2.6	2.4	-0.3	6.8	5.3	-1.4
France	2.4	1.7	-0.7	6.4	1.8	-4.6	11.3	5.9	-5.3
Italy	2.4	1.5	-0.9	9.9	3.8	-6.1	15.1	8.3	-6.8
UK	2.4	2.0	-0.4	6.2	3.2	-2.9	11.7	7.1	-4.6
OECD Major 7	2.7	2.2	-0.5	5.2	2.1	-3.1	10.3	5.7	-4.6

Source: IMF (World Economic Database), OECD

The Australian economy in the post-recession 1990s has been at the top of the OECD economic growth league table and has outperformed even the United States in terms of both growth and inflation performance. As Macfarlane (2000: 2) argued in a speech in September 2000, 'the fact that Australia has been virtually at the top of the international growth league, while achieving a respectable middle order ranking on inflation, shows that we have not over-emphasised inflation control at the expense of economic growth.' He admits, 'I'm regarded amongst the central Bank community as being a bit of a wet' (interview, November, 2001). Indeed, the RBA's approach has helped promote a less restrictive orthodoxy amongst central bankers (especially compared to the once-lionised New Zealand model) aimed at long sustainable expansions (Bell 2005). Commenting on the RBA's approach, Macfarlane thinks, 'there's been a shift in our direction. There is no doubt about that':

> The single [inflation] objective is being questioned… there was this sort of feeling that if you were a central banker and you were caught worrying about something other than inflation, well you know, you should be gotten rid of….that has certainly changed. I think the other thing too that has changed is there used to be a lot of veneration for the Bundesbank.. its representing orthodoxy. And I think of the success of the Fed, the US Fed, during the 1990s… the Fed has really got pragmatic…its got dual objectives. And so I think the success of the Fed and the

> demise of the Bundesbank have probably been the biggest single influences….[Also] the New Zealanders have made some mistakes as you know. I mean they had the recession they didn't have to have in 98 (interview, November, 2001).

Some international economists, such as Joseph Stiglitz (1998), have argued the case for 'cautious expansionism, suggesting that the costs of inflation have been overstated, the costs of disinflationary policies understated, and that evidence that moderate rates of inflation actually damage the economy is hard to find (see also Fortin 2001; Akerlof 1996; Bell 1999). Stiglitz also argues that the costs of higher inflation incurred in driving unemployment somewhat below the so-called 'structural rate of unemployment' or the NAIRU are likely to be small compared to the gains based on a more expansionary stance.

A more fundamental question is whether systems of inflation targeting will survive the upsurge in the prices of commodities, including energy, minerals and more recently food that has been driven by factors including the economic expansion of China and India. In a situation where rising inflation is combined with recession, as appears to be the case in the United States, the monetary policy associated with a Taylor rule may not be consistent with a target rate of inflation. The US Federal Reserve has avoided (or perhaps evaded) this problem by targeting a 'core' rate of inflation that excludes energy and food prices, but it remains to be seen whether this approach can retain credibility with CPI inflation rates approaching 5 per cent.

Beyond the Current Account

The great challenge for the Keynesian policymakers of the post-war era was that of maintaining simultaneous internal and external balance. In perhaps, the most important single Australian contribution to macroeconomic theory, Swan (1955, 1963) graphed internal and external balance and prescribed an appropriate mixture of fiscal policy and exchange rate policy to maintain equilibrium. Swan's analysis was particularly appropriate in the light of Australia's experience in the Great Depression, which was manifested first as a foreign exchange and foreign debt crisis. The policy imperative of maintaining a fixed exchange rate with sterling, which was in turn tied to gold, made any expansionary response to the Depression impossible.

By contrast, analysis based on the Swan diagram prescribed depreciation of the currency as the appropriate policy response to a problem of sustained trade deficits, combined with demand management based on fiscal policy to maintain internal balance. In practice, given the political costs associated with both depreciation and appreciation, policymakers adopted a range of instruments, including a lengthy period of import licensing, to maintain external balance. For several decades after

World War II, this combination of policies worked reasonably well. Although Australia was mostly in net deficit, and there was a steady stream of critical commentary on the extent to which this implied foreign ownership and control of major companies, the trade and current accounts remained reasonably close to balance.

After the breakdown of the Bretton Woods system in the early 1970s, management of exchange rates became more difficult. With other currencies fluctuating, the exchange rate was pegged to a basket of currencies and adjusted daily. The floating of the exchange rate in 1983 was expected to resolve the foreign exchange problem once and for all. Most analysts assumed that foreign exchange markets would adjust to bring trade in goods and service to a net position close to balance, without the need for government intervention. It was also assumed that, provided macroeconomic policy was stable, then exchange rates would also be relatively stable. Although speculation was expected, most analysts assumed that speculators would act as a stabilising force, buying the currency when the exchange rate fell significantly below its long-run equilibrium value, and selling when the currency was overvalued.

These assumptions were rapidly invalidated after the move to floating exchange rates. Global exchange rates were far more volatile than had been expected, and, far from bringing goods and services trade into balance, the relaxation of constraints on international capital flows facilitated the development of large and sustained imbalances**.** Australia was no exception to this pattern, and has experienced sustained current account deficits, averaging over 5 per cent of GDP, with a corresponding increase in net external liabilities, to around 60 per cent of GDP (Belkar, Cockerell and Kent 2007). These levels are very high by the standards of the period since World War II. Australia had much higher ratios of debt to GDP in the late 19th century and in the 1920s. In both cases, the growth in debt was followed by depression.

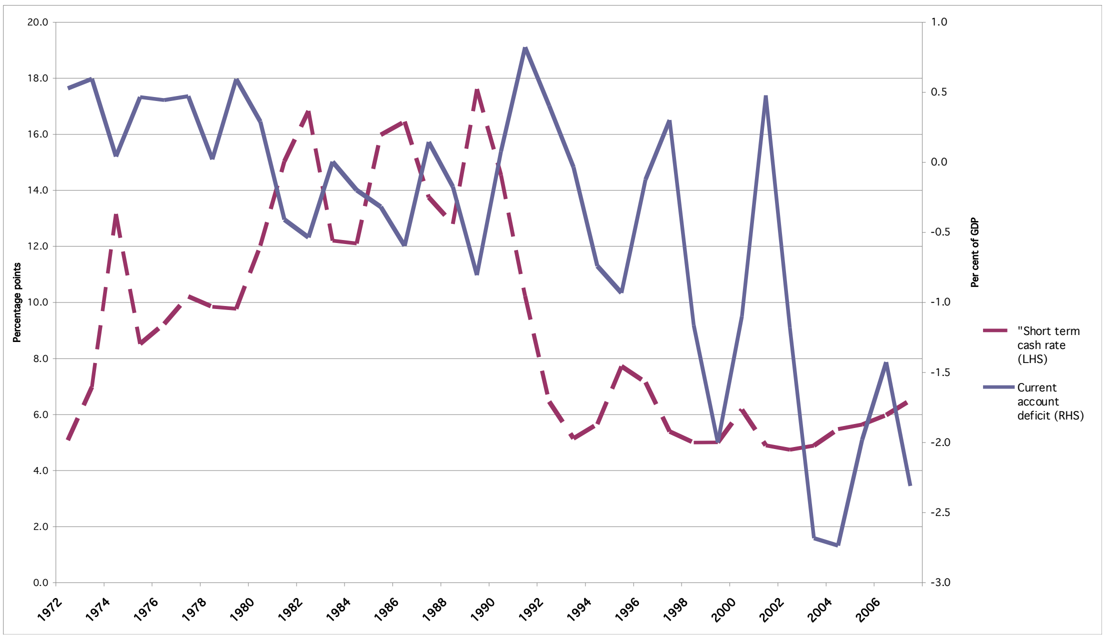
Policymakers responded to the growth of current account deficits and external liabilities on the basis of assumptions that reflected the experience of fixed exchange rate systems. Attempts to satisfy, and sometimes to manipulate, the expectations of financial markets were a central theme of economic policy in the 1980s. The appreciation of the Australian dollar after the float was seen as evidence that the market was confident in the future of the Australian economy and in its management by the Hawke-Keating government. It was in this period that Keating won the award from *Euromoney* magazine that led to his being labelled, sometimes seriously and sometimes derisively, as the 'World's Greatest Treasurer'. Conversely the sharp decline in the value of the dollar in the mid-1980s was seen as evidence that the market had lost confidence in the economy and its management, leading to mid-decade concerns about Australia becoming (in the Treasurer's words) a 'Banana Republic.' This crisis was managed successfully, with a short-lived increase in interest rates that depressed domestic demand, reducing the current account deficit and restoring market confidence in the Australian economy.

However, an attempt to repeat the ‘short sharp shock’ treatment in 1988 and 1989 went disastrously wrong, leading to the most severe recession in Australia’s post-war history. Although retrospective accounts, particularly from the Reserve Bank, present the operations of monetary policy as being primarily driven by concerns about inflation, many contemporary observers, such as Tingle (1994) were in no doubt about the fact that the main target of policy was the current account deficit. As Edwards (2006) notes, the Reserve Bank stated in its 1988 Annual Report that the tightening began as a response to higher imports threatening ‘the improving trend in the balance of payments’, as well as a response to growth in earnings and prices threatening ‘the downward trend in inflation’. It was widely argued that any relaxation of policy could not be undertaken until after a turnaround in the CAD had been observed.

The most prominent critic of the dominant approach was Pitchford (1989). In a series of articles and other publications, he argued that, following deregulation, the current account balance had ceased to be a relevant target for macroeconomic policy, and particularly the setting of interest rates. In the absence of large government borrowing, the current account balance was simply the aggregate of borrowing and lending transactions between individuals and firms in Australia and overseas. If these transactions turned out badly, that was a problem for the parties concerned, or perhaps for prudential regulation, but not for governments. This ‘consenting adults’ view achieved complete dominance in the aftermath of the recession, to the extent that it is virtually impossible to find anyone in a policy position who admits to having ever held the opposite view. The shift in emphasis away from monetary policy targeting the current account deficit is illustrated in the following chart. The shift clearly occurs after the Pitchford intervention.

Figure 2

Cash Rate and Current Account Deficit, 1974/75 – 2000/01.



Sources: Bell (2004, p54), Reserve Bank of Australia

The removal of, or at least the Reserve Bank's willingness to disregard, the external balance constraint has been a crucial factor in permitting the current long expansion. These days, neither the exchange rate nor the current account deficit is targeted. In the absence of such targeting, the current account deficit has remained at high levels, reflecting a decline in household savings. Many of these developments are common to the English-speaking countries as a group. In particular, the United States has also experienced large trade and current account deficits and a decline in household savings. As in Australia, the willingness of foreign investors to buy US securities, including bonds, equity and mortgage-based securities has been taken to show that the current account deficit should not be a target of policy.

The success of the policy of benign neglect regarding the current account has been underpinned, in recent years, by a reversal of the long-standing historical trend towards declining terms of trade for Australian resource exports, as a result of the massive growth in demand from China. The trade balance has improved, and capital inflows have been directed to investment in mining and related activities. The trade balance has improved, but remains in deficit. It is salutary to note that sustained surpluses of around 1 per cent of national income are needed if the ratio of foreign liabilities to national income is to be stabilised (Edwards 2006; Gruen and Sayegh 2005).

As long as the 'consenting adults' view continues to prevail globally, there seems little reason to expect that the external balance constraint will bite in Australia, even though the ratio of foreign liabilities to national income continues to rise, well beyond levels that have historically been regarded as unsustainable. The only real risk is that of a loss of confidence in the US, flowing through to other heavily indebted English-speaking countries in the same way as the Asian crisis, beginning in Thailand, spread throughout the region.

If such a loss of confidence is ever to occur, it seems likely that it will be precipitated by the credit market failures evident in the breakdown of the US sub-prime mortgage market, beginning in mid-2007. Thus far, however, although there has been some disarray in financial markets, the main effect has been to drive down interest rates on official US government debt, suggesting that confidence in the US financial system as a whole remains strong. The disappearance (or disregard) of the external balance constraint has been crucial in permitting the continuation of the long boom, well past the point when contractionary fiscal or monetary policies would have been applied in the past. The prosperity of the boom has been accompanied by steady growth in the ratio of external debt to GDP. It remains unclear at what level, if any, this ratio will ultimately stabilise and whether this process of stabilisation will be smooth or painful.

Conclusion

This paper has attempted to analyse the major drivers of Australia's pattern of stop/go economic instability from the mid-1970s to the early 1990s. We saw that the major proximate causes of instability were monetary policy induced recessions, particularly in the face of major inflation and current account challenges. The boom since the early 1990s has been marked by an absence of such challenges. Inflation has been successfully managed thus far and the current account has, in a remarkable turn around, ceased to be a target of policy.

Given the clarity of hindsight now obtainable regarding the current boom, what is somewhat surprising is that no one predicted it. Also, of note is that the boom has occurred in a neoliberal era that has been marked by major bouts of financial instability. Thus far in the current boom such forces have not wreaked havoc on Australia. Nevertheless, the challenges of asset inflation are unlikely to recede and may well worsen (Bell and Quiggin 2006). Also, the continued debt build up in Australia poses major potential challenges. Nor has the business cycle been banished. Here the most likely cause of the next major slow down could well result from slow downs in our major trading partners, such as China and the United States.

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