FAX 02 232 5170 (1187)

ATTENTION Mrs Alison Goldberg

A VOICE FROM THE WILDERNESS

by John Hyde

Of Economics and Fortune Telling

A definition of Economics favoured by Alfred Marshal was 'a study of mankind in the ordinary business of life'. Politicians, unionists and businessmen ignore economics at their peril but it is not the philosophers' stone - it is absolutely no good at forecasting speculative profits and there are few economist millionaires.

The Australian economy is in a mess not because of external events, such as the terms of trade, but primarily because many politicians of all parties thought they knew better than the economic advice they received from Treasury, Industry Assistance Commission and Reserve Bank officers. The advisers did not actually predict the future; they said to cabinet and unions, "If you go on the way you are all Australians will be poorer than they need be and the risk of a balance of payments crisis and unemployment increases." That is about as much of an economic forecast as is possible. They were not able to say the dollar will be worth less than 100 Yen in 1986.

The most reliable forecast about prices is that those who forecast them will be wrong as often as they are right.

Economic forecasting is like weather forecasting in that both the economy and the weather are so complicated as not to be fully knowable. But while weather forecasting is theoretically possible economic forecasting is not. The clouds do not allow forecasts to affect their behaviour whereas economic players do. As soon as a forecast is made public it becomes part of the economic environment.

If a wholly credible forecaster (there is no such animal) were to announce that the A$ was about to fall to US50 cents, it would fall immediately to the forecast level. There would therefore be nothing to be gained from trading the currency, since it would have to be traded at the lower price.

If another says the price of wheat will rise next year, it rises forthwith to next year's expected price minus the cost of holding wheat until then. If it becomes generally believed that the price is going to fall, stocks will be sold as low as is necessary to beat the slump. All prices will reflect the relevant costs of storage, handling and interest.

Autumn lambs will be dearer than spring lambs; but economics alone will not say whether they will be sufficiently so to cover the cost of getting the lambs through the summer. Central city property will be dearer than suburban property; but who knows whether it will increase in value faster? Economic forecasting is possible only to the extent traders cannot profit by it.

Fortunes are not made from public knowledge but from private knowledge and animal spirits.

The job of the economist, in the public or the private sector, is not to foretell the future but to explain reality. Chinese businessmen apparently understand this; they employ both economists and fortune tellers.

Everyone wants to know tomorrow's prices so as to make profits without risk or effort - trading profits. So economists are employed to be soothsayers. Some economists even manage to flog soothsaying around a lecture circuit. Because political and commercial speculators expect economists to be soothsayers and economists conspicuously fail in this, economic insights are often contemptuously dismissed by policy makers. Take the way our inflation got to be so much higher than our trading partners.

In 1978 Mr Anthony and Mr Fraser predicted that interest rates would fall by 2%. Throughout 1979 Reserve Bank economists refused to say what would happen to interest rates but kept repeating that, if rates were forced below the market, money supply and inflation would increase. With hindsight we can see that the economists were right but at the time cabinet, and in fairness be it said most others including those in the property industry, did not take The Bank seriously. The consequences are now all too apparent.

For as long as I can remember, Treasury has been pointing to the evils of wage fixing and indexation. As economists they could predict, as they did for the first Hawke Summit, the approximate cost of giving in to union demands.

As economists they could not predict the cost of holding out. While economics explains very tidily why unionists strike it has not yet come close to predicting how much strike there will be.

The economies of nations must live with politicians, business men and union bosses who are amateur economists holding views diametrically opposed to all that has developed in the tradition of Adam Smith. The amateurs believe that the purpose of work is production whereas trained economists believe it is consumption. In the economists' ideal world the consumers are sovereign whereas amateur economists believe they can improve on the consumers' choices with tariffs and regulations such as taxi plates and two airline agreements. They do this to protect established interests often in sunset industries. Because they cannot touch the sunrise industries they do not believe in them.

The amateur thinks in terms of absolutes; the economist in terms of the last or marginal unit. The statement that water is essential and therefore must be produced is probably true but it says nothing about how much water. The economist knows water may drown you or save you and the price of water (labour, health care, environmental protection or anything else) should depend on how much people want another unit of it instead of a unit of something else - the opportunity cost.

Failure to understand opportunity cost has resulted in needlessly expensive environmental protection, an anti-environmentalist back lash and less environmental protection than we could afford if we went about it economically.

Finally amateur economists (and some macro economists) believe it is possible to regulate production, wages and prices. Micro economists know that no one can know the wants of every buyer, or the resources of every supplier. Like the weather forecaster he knows he can't find the raindrops in the storm. The weather man knows it is pointless to tell the raindrops where to fall but politicians, bureaucrats and lobbyist have no similar humility. They try to control the detail of unknowable human behaviour. When they fail they blame economists for the mess.

The discipline of economics makes limited claims but within its field it has too good a track record to ignore.