

ANIMAL SPIRITS: WHY ECONOMICS IS DEAD

JOHANNESBURG: We all know that economics is a flawed academic discipline. Many of us like to mock economists and their inability to make accurate forecasts about anything. Unfortunately many of us don't realise how much policymakers rely on defective economic theory to steer the global economy. Sadly the financial management of many countries has been so defective that it has caused great harm to ordinary citizens. All of this has great relevance to South Africa at this time because of the debate around inflation targeting. After reading a brilliant book called *Animal Spirits* (full title below) which was written by two leading economists I am convinced that narrow inflation targeting is not the ideal economic policy for South Africa.

ECONOMIC FORECASTS ARE WORTHLESS

Economists can't even predict interest rates with any accuracy. *The Wall Street Journal's* "Survey of Economists" asks them to predict whether interest rates are going to rise or fall in the next six months. They don't need to get the size of change right, they just need to say whether rates are going to: rise, remain the same or fall. Since 1982 the economists have only been right 32% of the time. (Source: Nedgroup Investments as provided by Legg Mason & The Wall Street Journal) This shows that economists are very poor predictors – not really news to most of us – but it also shows that you should take any economic forecasts with a grain of salt.

This is a frightening because governments build long term plans (hopefully they plan) based on economic models with a range of predictions. As shown, the predictions are worthless and to compound the problem, the economic models are based on assumptions which are totally out of line with the real world. The negative impact of incorrect government policies has been seen in countries like Japan (1989) and Canada in the early 1990's, which were fairly catastrophic to the citizens of these two countries. Sadly, these well meaning policy makers were relying on flawed economic theory that was popular at the time. The Canadian policies were fairly similar to those being used in SA until the most recent budget – where they too had an almost zealous focus on inflation targeting.

SA TRADE UNIONS NOT KNOWN FOR ECONOMIC FORESIGHT

Free-market advocates have been very opposed to most of the policies promoted by trade unions in South Africa as they are inevitably interventionist. Many commentators have pointed out that the rigid labour laws are one of the main factors that are responsible for SA's stubborn high unemployment rates. These are labour laws that are promoted by the trade unions who seem hell-bent on making the labour market even more rigid and therefore more uncompetitive. Cynics would argue that trade unions are simply looking after their own interests. The jobs of their members are protected because it is difficult to downsize in bad times, so this protects the levies paid to the unions which is good for union management. This may be the main reason why trade unions are so opposed to "labour brokers" as their staff don't pay union subscriptions. Critics of the unions argue that a free labour market would encourage employers to hire more staff because they can downsize, if needed, during an economic downturn. Instead many employers try to outsource labour to external parties or they try to automate their businesses so that they don't need labour. In the long term, this is detrimental to SA's employment rate.

HOWEVER TRADE UNIONS MAY HAVE A POINT

Recent events such as the Financial Crisis have shown that the free-market is unable to heal itself after a crisis and that conventional, non-interventionist policies don't work. As a card carrying free-market capitalist, I have to say that the trade unions in SA might be right when they argue that narrow inflation targeting is totally wrong. Narrow inflation targeting means the SARB only controls inflation and ignores every other economic factor. I base my view on the work done for a book called "Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism". It is written by Nobel prize-winner George A. Akerlof and Yale economist Robert J. Shiller and is really worth a read if you want to know what is really going on in the world. They argue that capitalist economies have been very badly managed for decades due to an over-reliance on Monetarist policies based on theories promoted by luminaries such as Milton Friedman. As a result of these Monetarist policies, our own Reserve Bank has an explicit inflation target of 3% - 6% and has used interest rates as the primary tool to keep inflation within this band.

There is no doubt that a high inflation rate is bad for any economy but Shiller and Akerlof argue that reasonable inflation is good for the economy. They prove in their book that economies with some inflation tend to have higher employment which is a key objective for South Africa. I think the recent moves by Treasury and SARB where they have indicated that they will take cognisance of broader economic factors in addition to their inflation benchmark is very welcome. Many knowledgeable commentators have suggested that President Obama's advisors have been following the theories as laid out in "Animal Spirits" and perhaps our own economic planners have started to do the same!