

ASymmetric information

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New Zealand Association of Economists Inc.

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“Work for the dole?”

Someone has to...

[SB]



9 - 11 July 2008

Markets and Models Policy Frontiers in the AWH Phillips Tradition

- The 49th Annual Conference of the New Zealand Association of Economists
- The Australasian Meting of the Economic Society

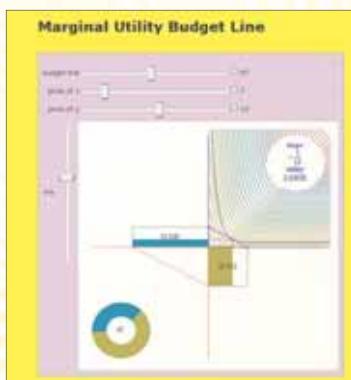
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EDITORIAL

Can we ignore the politics?

Stuart Birks (k.s.birks@massey.ac.nz)

The New Zealand Political Studies Association held its annual conference at the end of August. Despite the overlap of policy making and economics, very few economists attended. A large component of the conference was on the media. The discussion on political manipulation of the media and media manipulation of public opinion is far removed from Downs or the Impossibility Theorem.

One suggested problem is the dearth of investigative journalism. Instead, it was suggested that journalists either uncritically present material provided by PR organisations, or present their own opinions rather than information.

These issues aside, there are still problems with media presentation of policy-relevant information. Economics commonly relies on preferences being exogenous, and yet there are entire disciplines devoted to shaping them. One basic problem is the often-presented assumption that group characteristics can be defined by group averages. It is surprising that this is still common despite the criticisms raised in Simon Chapple's critique of "Closing the gaps".

Economists should be wary of assuming that public opinion is based on correct information rather than spin or fads. Moreover, the media may sometimes be passive players or reinforcers in much of this. To quote Alexander Cockburn, "The first law of journalism – to confirm existing prejudice rather than contradict it."¹

To turn to more mundane matters, next year's conference is a major event for economics in New Zealand. You are all advised to check the conference web page (<http://www.phillips08.org.nz/>) and note key dates. They are earlier than usual. There are the usual student activities, the poster competition and the Jan Whitwell Prize. In addition, there are 20 **Graduate Study Awards** of \$200 to go towards the costs of travelling to the conference for graduate students wanting to work as volunteers at the conference. This involves half day shifts, with students being able to attend sessions free of charge. For more details, see the web site.

To close, I have to advise you that the Association's secretary, Val Browning, has tendered her resignation, effective 30th April 2008. Her sterling contribution over many years will be acknowledged in the next issue, but I mention it now so that members have more than just a last-minute notification. □

¹ On p.226 of Sherrin, N. (ed.) (1995) *Oxford Dictionary of Humorous Quotations*. Oxford: Oxford University Press.

OBITUARY

Milton Friedman 1912-2006

Part III: Public Policy and Popular Contributions

James E. Alvey (j.e.alvey@massey.ac.nz)

In the previous two issues of *AJ* I dealt with Friedman's biography and 'scientific' writings. In this issue I will deal with Friedman's public policy and popular contributions. Friedman was a libertarian and these views were unfashionable in the period from the Great Depression until the late 1970s. In his role as a public intellectual, for many years Friedman swam against the tide of popular opinion. He lived long enough, however, to see the tide turn.

On New Zealand National Radio on 19 November 2006, the current Reserve Bank Governor called Friedman one of the 'rock star' economists and, in this context, mentioned names like Adam Smith, J.S. Mill and Keynes. By the term 'rock star,' I assume that Dr Bolland had in mind something like the canonical economists treated by Heilbroner in *The Worldly Philosophers*, his introductory history of economic thought book. In my view, Friedman was one of the three most *influential* economists in the twentieth century (Keynes and Hayek perhaps surpassed him). Would he have been elevated to the 'rock star' status solely on the basis of his 'scientific' contributions? Perhaps, but it is interesting that Dr Bolland stated that Friedman had two big ideas: money and small government. Much of Friedman's popular writings and policy advice concerned the latter: how to increase the role of markets and reduce the role of government.

Friedman was active in promoting public policy. Much of this advocacy was conducted in popular writings with his wife Rose; in addition, Friedman enthusiastically engaged in public debates and even presented his views on television. In 1962 he wrote a popular book called *Capitalism and Freedom*. Here Friedman set out his broad philosophy and some of the policies that followed from it. He wrote triweekly columns in *Newsweek* from 1966 to 1984. Friedman's first television series, *Free to Choose*, was presented on the American PBS network, the BBC, and elsewhere. A popular book with the same title resulted (with Rose, 1980). (The Federal Reserve Bank of Dallas recognized the importance of this book by sponsoring a special conference devoted to it [see the Proceeding retrieved from <http://dallasfed.org/research/pubs/ftc/ftc.pdf> on 3 December, 2006]). A little later, in 1984, he wrote (again with Rose) *Tyranny of the Status Quo*. This book was linked to a television

Members are invited to submit a brief article on any issue of interest to NZAE members, and/or comments and suggestions. Enquiries and contributed articles should be sent to Stuart Birks [k.s.birks@massey.ac.nz].

Views and opinions expressed in these articles are those of the authors, and do not represent the views of the New Zealand Association of Economists

series of the same name broadcast on the PBS network. Here Friedman showed his disappointment with Reagan's attempts to wind back the role of government.

As I stated last year (obituary of Galbraith *AJ* July, 2006, 26: 3-4), Friedman often engaged in public battles with Galbraith (his first television series was clearly designed to counter Galbraith's earlier television series, *The Age of Uncertainty*). The two men must have made quite a sight in campus debates: the 5 foot 2 inch Friedman standing next to the six foot seven inch Galbraith. If Friedman was a 'rock star,' this had nothing to do with his physical stature.

What sorts of public policies did Friedman advocate? Some of the policy proposals derived from his 'scientific' work. In the domestic economy, Friedman's monetarism embraced a framework which included 'goals' (price stability), 'targets' (a fixed rule of money supply growth), 'instruments' (government-issued money which was both a reserve requirement of banks and under the government's control) and 'policy authorship' (monetary policy officials directed by the executive in a democratic polity) (W. Coleman 'Milton Friedman on the Wallaby Track' *Policy* 23(2): 4). The view of goals, policy authorship and, to some degree, targets, can be traced back to Friedman's 'scientific' work. As I argued in Pt II of this series (see *AJ* July 2007, 29: 3), Friedman came to reject the Keynesian view that monetary policy should be used to achieve full employment; this led him to conclude that the goal of monetary policy was price stability. The monetarist view of 'policy authorship' stemmed from Friedman's studies (with Schwartz) of American monetary history which showed that the Federal Reserve played a destabilizing role in the Depression. Friedman formed the view that discretion in monetary policy conduct should *not* be given to central bankers. In the absence of discretion, Friedman was drawn to targets based on rules. Having established the outline of his monetary framework, Friedman began to consider money in the open economy context. As a result of his work on monetary theory, he concluded that a fixed rate of growth of the money supply was not attainable under a fixed exchange rate. Friedman therefore began advocating flexible exchange rates in 1953.

How does Friedman's monetary framework look today? Flexible exchange rates have become mainstream. Friedman's stress on the goal of price stability came to be widely adopted; indeed, over the long run around the Western world, especially in New Zealand, price stability came to be seen as the primary goal of macroeconomic policy. This priority accorded to price stability was a triumph for Friedman. The rest of the monetarist framework has not survived, partly because money supply targeting proved to be more difficult than Friedman imagined. The target is

now the inflation rate, the instrument is now the official cash rate (the price rather than the quantity of money) and the policy author is an independent central bank (Coleman *op cit* p. 5).

Outside of monetary policy, many policies that Friedman advocated seem to arise from his libertarian philosophy, as spelt out in *Capitalism and Freedom*. In an obituary of Friedman, Allan Meltzer refers to twenty-five policy proposals in Capitalism and Freedom ('An Appreciation' *American.com* retrieved from <http://american.com/archive/2006/november/an-appreciation> on 3 December 2006). Meltzer goes on to mention Friedman's four major successes: 'ending the military draft, floating the dollar and other currencies, removing interest rate ceilings on bank deposits, and auctioning government debt.' I will elaborate only on the first point.

Friedman played a leading role in the Gates Commission (1969-70), arguing that conscription was a tax (retrieved from http://www.rand.org/pubs/monographs/MG256/chapter4_sec4.html on 3 December 2006). The commission's recommendation for an all-volunteer army was implemented soon afterwards. Friedman has stated that his work on this commission gave him the most satisfaction of any public policy activity in which he had engaged (*Two Lucky People* Chicago: University of Chicago Press, 1998, p. 381).

Dearest to his heart in his final decades was school choice (see Pt I in *AJ* March 2007, 28:6). Friedman began to advocate education vouchers in 1955 and kept promoting this policy for the next fifty years. The movement that he inspired has achieved limited success in the US. The school choice movement has had an impact in New Zealand (the 'Tomorrow's Schools' programme). Indeed, the NZAE was involved in the publication of Caroline Hoxby's *School Choice* (Wellington: Education Forum, 2005).

Friedman's role as an economic adviser led to considerable abuse. He was an informal economic adviser to several Republican candidates in their Presidential campaigns: Goldwater (1964), Nixon (1968), and Reagan (1980). He was a member of President Reagan's Economic Policy Advisory Board. Perhaps his most controversial role was as an unofficial adviser to General Augusto Pinochet Duarte, the former Chilean dictator.

Friedman also joined the libertarian Mont Pelerin Society founded by Hayek in 1947; he later served as its President (1970-2). The Society was accused by its critics of being a secret cabal plotting against social democracy. It is interesting to note that four other Nobel Prize winners in economics have served as President of the Society (Hayek, Stigler, Buchanan, and Becker).

Friedman came to be seen as a sort of hero for the political and economic right. In May 2002, President George W. Bush, at a celebration of Friedman's ninetieth birthday, called him a 'hero of freedom' (see http://www.cato.org/pubs/policy_report/v24n4/hero-freedom.pdf retrieved on 5 December, 2006). Other conservatives and libertarians (such as William F. Buckley and Alexander Tabarrok) have also called him a hero.

Unlike Galbraith, Friedman was not a literary stylist. He was, nonetheless, a relentless, effective and persuasive communicator. His unfashionable views, his looks (including his height and baldness), and his pedestrian writing style, ensured that (unlike Galbraith) he was never one of the 'beautiful people.' Despite his claims that his 'scientific' work is separate from his role as public policy activist, they are mutually dependent. As I suggested in the second part, his methodology is debatable. Nevertheless, he was highly influential inside and outside of the economics profession. As indicated in his autobiography, he was lucky, and especially lucky to be on the right side of history. □

JAN WHITWELL PRIZE

The Jan Whitwell Prize is an award to honour the memory of Jan Whitwell (1944-1993), a former President of the New Zealand Association of Economists (1992-93), distinguished university lecturer and musician. Jan Whitwell died in a road accident in October 1993.

CONDITIONS

- 1] Entry to the Jan Whitwell Prize is open to persons who are either engaged currently in full time study or have completed a thesis or full time study during the preceding eighteen months, and are able to attend and present their paper at the Conference. Entries from overseas that meet these criteria will also be accepted.
 - *Deadlines for Submission of Abstract and Full Paper as detailed on the conference website, must be complied with.*
- 2] Participants must also comply with Conference Registration deadlines as detailed on the conference website.
- 3] **Solo authored papers only are eligible for the award.** Please note on your abstract submission that you wish to enter the Jan Whitwell Prize.
- 4] The prize is awarded for the *best presented* paper.

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FOR FURTHER DETAILS & REGISTRATION SEE WEBSITE

FROM THE 2BRED FILE

Grant M. Scobie (grant.scobie@treasury.govt.nz)

Your reviewer has just returned from Washington DC where **Alan Greenspan's** new book *The Age of Turbulence: Adventures in a New World* (New York: The Penguin Press 2007) is all over town - airport check-ins, all the book and magazine stands, 15% off from street sellers and a free coffee if you buy your copy at Starbucks (well actually I managed to adhere to my Starbucks-free strategy, but I reckon they are selling it - everyone else is).

Sales have no doubt been boosted by the reported size of the advance from the publishers. My usually reliable sources in DC tell me that Mr Greenspan collected \$US15m, nearly twice that paid to Bill Clinton. Which just goes to confirm what we economists always knew - monetary policy is more fun and sells better than sex scandals. A cynic might argue that the autobiographies of the famous are written precisely to lock in a retirement fund (or pay the legal bills and fund your wife's presidential election campaign). Be that as it may, Greenspan has produced a splendid volume, which I heartily recommend. It is full of economic history in the making, political and financial crises (October 1987 and 9/11), insights into how "the system" works, and above all, a warm human touch.

Even had he never been Chairman of the Council of Economic Advisers (1974-77) and Chairman of the Fed (1987 to 2006) his would have been a life story worth reading. He had the usual "local boy makes good" origins in a lower middle-income immigrant area of New York City - yet his recounting is far from maudlin. He studied the clarinet at the Juilliard School of Music, and spent a year playing in a band that toured the USA (and doing the band members' tax returns on the side!). His professional career spanned half a century and his positions took him on to a global stage; whatever serious international development that occurred on his watch (the Cold War, Vietnam, the Asian Crisis, oil prices, Mexico's default, the Berlin Wall), there were inevitable implications for the US financial system, and his book gives us an insight into the interwoven nature of political, military and economic events.

He addresses "academic" puzzles (why are computers everywhere except in the productivity measures?) and throughout draws on the work of other economists to help him gain understanding. His closing chapter on to whither we are tending brings together his command of international affairs while showing a true warmth and humility - but one filled with optimism about the capacity of people everywhere to adapt. All capped with an excellent bibliography and a splendidly detailed index.

Who said economists with their arcane jargon can't write anything intelligible to anyone but fellow economists? Well, one must concede that a few journals (NZ Economic Papers not included of course) make a specialty out of striving for a monopoly position built on an unholy cross between the unreadable and the irrelevant.

But it now seems that there is a never-ending stream of books aimed somewhere between the general reader (that mythical intelligent layperson) and the airport bookstand market.

Of course this is hardly a new phenomenon. Would one not actually include **Adam Smith**? And surely **Frederic Bastiat** would qualify. I never tire of re-reading his "*Petition From the Manufacturers of Candles, Tapers, Lanterns, Sticks, Street Lamps, Snuffers, and Extinguishers, and from Producers of Tallow, Oil, Resin, Alcohol, and Generally of Everything Connected with Lighting To the Honourable Members of the Chamber of Deputies*" (Sophismes économiques, 1845), see: <http://bastiat.org/>.

I would hazard a guess that **Gary Becker's** application of a household production function to everything from crime to education and marriage was an important springboard for much of what was to follow. Among more recent examples of top economists writing for the bestseller list I would add:

- **Harry Johnson** - *The Daily Economist*
- **Angus Black** - *A Radical's Guide to Economic Reality*
- **Miller, Benjamin and North** - *The Economics of Public Issues*
- **David Colander** - *Why aren't Economists as Important as Garbagemen*
- **Steven E. Landsbur** - *The Armchair Economist*, and doubtless we would have to add
- **Stephen Dubner and Steven Levitt** - *Freakonomics*

I enjoy these, and often find they suggest improved ways of making a simple argument out of a complex idea, or just offer a new illustration of an economic principle. Perhaps those authors who divert themselves from writing another few scholarly articles (in all likelihood read only by the journal reviewers) are only preaching to the converted. Do they really reach the great unwashed?

Be that as it may, the flow continues – and it seems especially useful for marketing to have a catchy title. **Tyler Cowen**, a scholar with unswerving faith in markets certainly tops the current crop (do notice the eye catching picture of a

carrot on the dust jacket). He (or his publisher's marketing department) entitled his latest book *Discover Your Inner Economist: Use Incentives to Fall in Love, Survive Your Next Meeting and Motivate Your Dentist* (New York: Dutton, 2007).

So what does Cowen¹ really want to say? That's easy: Incentives matter! His challenge of course is to convince the reader that it is not just monetary incentives as many would assume, coming from an economist. A smile, or pride in one's work, or acknowledgement of a task well done are all-important in what makes us respond.

But before you dismiss this as another bit of pop-psychology that Whitcoulls should put in the Self-Improvement section at the airport, have a close read. Understanding real incentives really does matter – if you want to reduce crime forget about the long-term training courses or stiffer penalties, and start understanding how criminals actually think and what the real incentives are that drive them.

I especially liked Cowen's three principles for distinguishing good economics:

- **The Postcard Test:** Can you write the argument on a postcard?
- **The Grandma Test:** Can your economic argument be understood by your granny?
- **The Aha Principle:** Does the economics make sense and stimulate the "Aha" part of the brain?

I must confess to being quite a fan of **Tyler Cowen** so when I happened to light upon an earlier volume of his that recently appeared in our house, I delved immediately. *In Praise of Commercial Culture* (Cambridge, Mass: Harvard University Press, 1998) is an economist's view of literature, art and music. In some circles one will hear the argument that globalisation is behind the demise of local culture; that minority languages arts and associated culture cannot survive in the face of the relentless Disneyfication reducing the world's cultural tastes and menu to a homogenised global puree built on the lowest common denominator.

Cowen makes the case that market forces are in fact the handmaiden of enhancing creativity, paying homage to past and providing niche outlets for far greater diversity for both high and low culture. For a long time I had been persuaded by Baumol's "cost disease" argument. He noted that the production of a Mozart symphony in 2007 would take the same capital and labour as it did in 1780. As a result the relative price of the arts would rise, as the production of artistic work did not enjoy the same productivity gains as other sectors of the economy. And much theatre and music would hence only survive if subsidised by the state.

¹ If you have yet to visit his blog ("the best economics blog in the universe"), I do recommend <http://www.marginalrevolution.com/marginalrevolution/>

Cowen presents evidence to the contrary – a wide range of technological innovations from paper and printing, to chemicals for colours, to advance recording techniques, DVDs (and we could add iPods and the internet) have all contributed to making the production and dissemination of a wide range of art forms more efficient. At the click of mouse we can have jazz, rap, Nepalese folk music, the writings of Gabriel Garcia Marquez, stories of Lake Wobegon by Garrison Keillor or Pablo Neruda's poems. We have especially enjoyed podcasts of lectures on science, economics, philosophy... whatever... when we make a long car trip. So much for globalisation eliminating art and culture. Isn't myth busting fun?!

Maximize the bums on seats in a marketing or business communications course next semester. It surely would not turn the class on to economics!! But Harford will. He has a superb knack of taking the everyday and leading the reader through the simple economics of a cup of coffee, traffic congestion, second hand cars, why some countries are poor, why China grows so fast and why globalisation beats the alternative.

As a trained economist and a lead writer for the World Bank, he combines a sharp eye, great logic and clear writing. The book is relieved of heavy scholarly footnoting and referencing, but the extensive notes to the Chapters document the sources of his stories and shows a command of the serious (but boring?) literature that underpins his writing.

A novel way of viewing issues in the development of economics comes from David Colander, Richard Holt and J. Barkley Rosser in their book *The Changing Face of Economics: Conversations with Cutting Edge Economists* (Ann Arbor: University of Michigan Press, 2004). Interviews, which make up this book, can vary from the insightful to the maudlin. These are much more in the former camp you will be relieved to know. The book grew from a perceived need to demonstrate to the post-Keynesian fringe of the profession that the mainstream did have new and exciting developments going on inside it.

So if you want to catch up with thinking of those who are arguably among the front runners and see how their work is contributing to recent developments in economics, this could be a great place to start. Of course there will always be debate about who should be included but with McCloskey, Binmore, Gintis, Frank, Rabin, Brock, Foley, Norgaard, Axtell, Young, and commentaries by Arrow and Samuelson, then one has a formidable selection (if somewhat yanquicentric). But this one is more for your scholarly moments than to add to the bedside table.

Without a doubt one of my favourite writers is Thomas Sowell. And what a prolific writer. A quick check at <http://www.tsowell.com/> confirms that he produces a new volume about every 18 months. And I realise I have been slipping behind in keeping you up to date – my apologies, dear reader. I solemnly undertake to do better and enrich 2BRED with more Sowellian gems in future columns. In the meantime, permit me to cover my tracks a bit and take you back. *The Vision of the Anointed: Self-Congratulation as a Basis for Social Policy* (New York: Basic Books, 1996) had escaped my notice, more is the pity.

In this book Sowell paints a picture of a small but influential elite intelligentsia, who aided by politicians and the media have increasingly set the social policy agenda in their vision. A blend of liberalism (in the US sense of the term), political correctness and social engineering. In short, a bunch of well meaning folk who are out to make the world a better place according to their vision of how which should think and behave.

The privileged students of the Sorbonnes of Paris who led the recent riots, tore themselves from their books to protest against labour market reforms. Their vision was a world where strong labour market regulations were there to protect the weak from the exploitations of greedy business. As a number of more astute commentators observed, the irony that by preserving the existing laws they were entrenching their favoured status at the expense of the poor unemployed Muslim migrant worker, did seem to be lost on them in the excitement of the revolutionary moment.

This example typifies the approach taken by Sowell. He examines the vision created by a group in society and then explores the ramifications in a wide range of social policy and judicial rulings. He carefully looks at the evidence and compares "the promised benefits of policies based on that vision (with) the grim and often bitter consequences of those political and judicial decisions". Tax dollars can be invested in the industries of the future, irresponsible mothers taught parenting skills, criminals can be rehabilitated, pay equity can be achieved by legislation, sentences are reduced because the victim had a childhood less happy than that of the anointed. In short, as Sowell argues, in a world where reality is seen to be socially constructed, there is no end to the scope for deconstruction and recreation to fit the vision. □

Perfect Competition and Counterfactuals

by Stuart Birks (k.s.birks@massey.ac.nz)

Mainstream economic theory defines an ideal economy as one with perfect competition everywhere. Market failure is defined in comparison to this ideal. This raises two questions. First, should our analyses involve comparing a real situation with an ideal that is unattainable? The counterfactual is not a feasible situation. However, the specification of a counterfactual is an important aspect of many analyses. Second, is perfect competition the right "ideal"?

First consider the issue of counterfactuals. In epidemiology, four alternatives have been suggested as counterfactuals in relation to risk of disease. These are *theoretical minimum risk*, *plausible minimum risk*, *feasible minimum risk*, and *cost-effective minimum risk* (Murray & Lopez, 1999). These represent, in turn, the lowest risk imaginable, even if highly unrealistic; the lowest risk that might be considered possible, even if not currently realistic; the lowest risk that has been achieved somewhere, and thus is known to be attainable; and the lowest risk that could be achieved using all cost-effective means available. The economic "ideal" counterfactual would roughly parallel the theoretical minimum, while the others reflect the best we might ever expect to achieve, or the best that has been observed elsewhere, or the best that could be currently achieved using approaches that are known to be cost-effective.¹

The theoretical ideal could still be used as a measure of the extent to which imperfections lead to sub-optimal outcomes, and this may have some value. However, for policy purposes we should not forget the Theory of Second Best (Lipsey & Lancaster, 1956). If it is not possible to create all the conditions required for the optimal position, then it may not be beneficial to come closer to achieving some of them. In other words, perhaps we should be aiming for some other goal, as suggested by the alternative counterfactuals.² There are significant information requirements that would have to be met in order to specify these alternatives, but the problem may not be entirely insuperable. Ng (1983) suggests "third best" solutions where numerous decisions are required over time. These involve following strategies that are designed to give the best expected outcomes given imperfect information and uncertainty.

Second, a more fundamental problem is the choice of perfect competition as the starting point. Theory is, in

essence, an intellectual exercise whereby structures are presented and implications drawn. There is no a priori reason to assume that they in any way accurately reflect, or even closely approximate, the real world. Amartya Sen summarised the situation in his paper on "Rational Fools":

I am concerned here with the view of man which forms part of Edgeworth's analysis and survives more or less intact in much of modern economic theory. The view is, of course, a stylized one and geared specifically to tackling a relatively abstract dispute with which Spencer, Sidgwick, and several other leading contemporary thinkers were much concerned--namely, in what sense and to what extent would egoistic behavior achieve general good? Whether or not egoistic behavior is an accurate assumption in reality does not, of course, have any bearing on the accuracy of Edgeworth's answer to the question posed. Within the structure of a limited economic model it provided a clear-cut response to the abstract query about egoism and general good. (pp. 320-321)

So economists have moved from "here is a nice intellectual exercise" to a combination of both "this is how people actually behave" and "this is how people, should behave" (see *Asymmetric Information* No.25, p.9).

- Lipsey, R. G., & Lancaster, K. (1956). The General Theory of Second Best. *The Review of Economic Studies*, 24(1), 11-32.
- Murray, C. J. L., & Lopez, A. D. (1999). On the Comparable Quantification of Health Risks: Lessons from the Global Burden of Disease Study. *Epidemiology*, 10(5), 594-605.
- Ng, Y.-K. (1983). *Welfare economics : introduction and development of basic concepts* (Revised ed.). London: Macmillan.
- Sen, A. K. (1977). Rational Fools: A Critique of the Behavioral Foundations of Economic Theory. *Philosophy and Public Affairs*, 6(4), 317-344. □

The **2007 APEC Economic Policy Report**, (APEC Secretariat, 2007)

is at: http://www.apec.org/etc/medialib/apec_media_library/downloads/committees/ec/pubs/2007.Par.0001.File.tmp/07_ec_AEP_Fnl.pdf

On p.30:

...a review agency can still have influence, even if it can sometimes be ignored, for several reasons:

- transparent processes have influence, and such an agency can identify the winners and losers from current policy setting; and
- ideas have influence, and such an agency can formulate reform proposals with high-quality intellectual backing.

¹ While economic theory is based on an equivalent of theoretical minimum risk, the econometric approach of frontier analysis is analogous to feasible minimum risk. This is one of several cases where economics and econometrics are based on different criteria. Another example is that they have different concepts of the short run and the long run. Also, econometrics tends to estimate average relationships, whereas economics focuses on marginal changes.

² Allan Rae has suggested that one reason for failure to reach agreement in international trade negotiations may be that the parties do not have a common interpretation of the situation. They are not all aiming for the theoretical ideal of free trade, but rather they each have their own alternative counterfactual in mind. This raises another point, namely that, where coordinated action is required, it may be better to have a common view that is incorrect, rather than individuals holding diverse views, each of which more accurately reflects the circumstances that each individual faces. If so, it may be preferable that participants only have a vague (but common) understanding of the issues.



Insights from the Island

Recent findings from Motu Economic and Public Policy Research, in short form.

The role of immigrants in New Zealand society has been in the public eye recently. In one example, a Reserve Bank submission to the parliamentary enquiry on housing affordability, subsequently quoted by the *New Zealand Herald*, suggested that immigration policies are contributing to house price inflation. A number of recent papers have also examined income and labour market outcomes for immigrants in New Zealand.

However, an analysis of immigrant wealth has not been available. The official report from the Household Savings Survey (Statistics New Zealand 2002) considered how net worth varied with age, gender, ethnicity, occupation and employment status, but not by nativity or immigrant status.

Recent research from Motu examines the wealth gap between immigrants in New Zealand and New Zealand born.

Wealth vs Income

The Motu paper argues that wealth is an important measure of economic well-being which may not be accurately captured in the income and employment studies. It points out that differences in wealth are notably reflected in educational investment. If immigrants are unable to invest in education at the same rates as their native-born counterparts this has the potential to perpetuate differences in wealth and slow immigrant assimilation.

The data and the gap

Motu's research revisits data from the Household Savings Survey (HSS). The HSS is based on responses from 1,682 singles (1,498 New Zealand born, 184 migrants) and 2,565 couples surveyed together (1,915 New Zealand born, 262 both migrants, 388 of mixed nativity).

The researchers found no significant differences in the wealth of immigrant and native single respondents

(those differences which emerged with additional factors included were almost entirely explained by variation in the age distribution of the two groups). However, a different picture emerged for couples: while mixed and native couples pattern together, migrant couples have \$141,500 lower mean wealth than native couples and \$74,000 lower median wealth.

Other factors

Age, education, income and inheritance history contribute to the accumulation of wealth. What happens to the reported differences when these factors are controlled?

Focussing on differences between migrant and native couples, an approach that considers the whole wealth distribution shows that migrants have less wealth than NZ-born at all points (excluding at the 10th percentile), with this gap increasing monotonically at higher quantiles. The gap is unexplained by age, education, income or inheritance at the 10-30th percentiles, as well as the 90th percentile. However, in the remaining part of the distribution, one-third to one-half of the gap can be explained by two factors, lesser inheritance and lower incomes, in roughly equal measure.

Next steps

This research answers some of our questions about immigrant wealth. Migrant couples have significantly lower unconditional wealth than NZ-born couples at all points in the wealth distribution, and this is only partially explained by additional factors. Of course, there is still much to explore. The HSS does not record migrants' country of origin, nor does it record whether migrants applied as skilled migrants or through family reunification or humanitarian streams.

Motu is currently awaiting data from the Survey of Family Income and Employment (SoFIE) to continue this research stream. SoFIE will provide biannual longitudinal data on wealth and also records nativity, years in New Zealand and country of birth.

This research is published as Gibson, John; Trinh Le and Steven Stillman "What Explains the Wealth Gap Between Immigrants and the New Zealand Born?" Motu Working Paper 07-12. All Motu publications are available at our (new!) website: www.motu.org.nz. □

MEASURING SAVINGS

NZIER working paper 2007/01, "Does New Zealand have a saving crisis?" is available online via: http://www.nzier.org.nz/Site/Publications/NZIER_reports_working_papers.aspx. It discusses measurement issues and questions some commonly-held beliefs about low savings rates. Much higher rates can be achieved if expenditure on health and education are included as investments from current savings, but interpretation can be difficult without comparable measures from other times or other countries.

Fireworks and preferences

by Stuart Birks (k.s.birks@massey.ac.nz)

A few months ago, if you had asked people if they were in favour of the public being able to buy fireworks, they might have been strongly in favour. In the first week of November there was a series of media stories about the dangers of fireworks, with prominence given to one poor girl who suffered burns in her pram. Opinion now may well have swung in favour of a ban on fireworks, in line with the stated views of several politicians.¹

There are some data on New Zealand horse riding morbidity and mortality data for 1993 to 2001 in Northey G ((2003) "Equestrian injuries in New Zealand, 1993–2001: knowledge and experience", *NZMJ*, 116(1182), 26 September, <http://www.nzma.org.nz/journal/116-1182/601/>

These indicate on average close to two hospitalisations per day. By comparison, in the weekend leading up to Guy Fawkes there were "at least five people hospitalised with fireworks injuries", according to an NZPA report (<http://nz.news.yahoo.com/071105/3/2azv.html>

It says in the *NZMJ* article, "Sport and Recreation New Zealand's 2001 data stated that horse riding and equestrian sport and leisure activities in New Zealand had a participation rate of 5% over a 12-month period for New Zealand adults, and 9% for those aged 18 to 24." It is unlikely that all these people participate every few throughout the year. We could speculate on the participation rate for fireworks celebrations, but it is likely to be over 10% of the whole population, and it would be concentrated in a short period. Consequently, we could reasonably assume that the hospitalisation rate from fireworks is certainly no worse than for horse riding. Conservatively, then, fireworks could be considered less dangerous than horse riding.²

As for overall costs and benefits from fireworks, that is hard to tell. If people choose to participate, knowing the risks, we could reasonably assume a positive net benefit. It may be hard to measure the precise benefit, though. One difficulty is that people's preferences may be altered as a result of the media focus. Are people being "softened up" to accept a policy change on fireworks? If so, is this softening up equivalent to talking up people's perceptions of the costs? In other words, elicited preferences, if not underlying preferences, may be endogenous and subject to political/media manipulation. Such a presumption may be taken for granted by politicians, but problematic for economists. If it is valid, and preferences can be manipulated, what, then, could we say about the use of contingent valuation as a basis for policy decisions? □

¹ For Helen Clark, see, NZCity (2007) "PM's fireworks ultimatum reserved", 5 November, <http://home.nzcity.co.nz/news/article.aspx?id=78401&fm=newsmain,nrhl>. For John Key, see, Trevett C, Vass B and O'Rourke S (2007) "Fireworks ban inevitable - Key", *NZ Herald*, 7 November, http://www.nzherald.co.nz/section/1/story.cfm?c_id=1&objectid=10474474&ref=rss.

² A similar policy example can be found in the UK. Following publicity surrounding crashes with commuter trains, measures were taken to improve rail safety when it would have been more cost-effective to spend the money on road safety. See Jones-Lee M (2002) "An Anomaly in the Valuation of Transport Safety 2002", *Applied Health Economics and Health Policy*, Vol.1(1), pp.7-8

Can a society save to provide for an aging population?

by Stuart Birks (k.s.birks@massey.ac.nz)

It is all very well calling for increased saving for retirement, but will it solve the country's problem? When an individual saves, the individual's consumption out of current income is foregone, thereby making currently produced goods and services available for others. In exchange, the individual retains money, which can be used to lay claim to goods and services produced in the future. Conversely, others borrow the saved money and use it to purchase currently produced goods and services. There is a reallocation in the present and associated balancing claims for the future.

Can the same reasoning be applied to an entire society? If a society foregoes claims on its currently produced goods and services, the output could be stockpiled for future use, or sold to other countries, or it might go to waste if it is perishable. In a closed economy (or an entire global society) with no stockpiling of output, individual saving is simply resulting a reallocation of current output among the existing population. The only way that this can provide for increased output in future is if the savings are applied to output-enhancing investments. Failing that, the savings are only giving a claim to the future cake.

In other words, current saving for tomorrow's old people is a means of ensuring that those people can lay claim to a share of future output. We will be competing with our children for a share of the cake that they will be producing. An alternative to savings would be taxpayer-funded superannuation, but the size of this allocation would depend on decisions by future politicians and voters, including the taxpayers of the future. There are likely to be problems in either event if the future cake is not large enough, and an aging population would most probably be associated with a rising dependency ratio of elderly to workers. More problematically, the demands of the elderly may well be skewed towards personal services such as home care and health care. For these, economies of scale are limited, and so their relative costs are likely to increase.

It would therefore be wrong to assume that it is enough simply to encourage saving for old age, and to assume that the required savings can be determined on the basis of current relative prices. The issue is not purely one to be addressed in the financial sector. Provision of real goods and services for the elderly is a problem that must be addressed with regard to the real sectors of the economy. It is not clear that such concerns have been incorporated into the debate. □

RESEARCH IN PROGRESS...

Continuing our series on the research projects currently underway in Economics Departments and Economics Research Units throughout New Zealand, in this issue we profile the research currently being undertaken by economists at the University of Canterbury. The objective of this section is to share information about research interests and ideas **before** publication or dissemination - each person was invited to provide details only of research that is **new** or **in progress**.

... economic research at the University of Canterbury as at November 2007.

Compiled by Seamus Hogan (seamus.hogan@canterbury.ac.nz)

Jeremy Clark is currently working with co-author Chris Bruce on experiments testing whether subjects in cooperative bargaining without side payments reach the Nash Solution when it coincides with or conflicts with outcomes that maximise joint earnings or outcomes that equalize final earnings. The experiments are being used to gain insight into the method of solving public land use conflicts that has interested stakeholders negotiate in the shadow of a government-imposed backstop solution.

Eric Crampton is working on a few projects including the effects of method of election on MP committee choices under MMP and differences between contingent valuation and revealed preference in GMO food choices. Crampton also is working with Glenn Boyle of U Vic toward the establishment of a New Zealand election stock market. Crampton's working papers and further information are available at <http://www.econ.canterbury.ac.nz/erid>

John Fountain is currently working on three research projects. (1)The theory and experimental methods for belief elicitation (with Glenn Harrison and Lisa Rutstrom). The theory extends and ties together literature on scoring rules and prediction markets. (2) A modern empirical transaction costs analysis of NZ High Country Land policy and the Quigley/Evans Brower/Meguire debate on this policy. (3) The synthesis of statistical information theory methods of conceptualizing and measuring the quantity of information in a system, the theory of proper scoring rules, and duality methods for investigating equilibria and optimal choice in contingent commodity markets such as sports betting markets.

Alfred Guender has just published his "Optimal Monetary Policy under Uncertainty" (joint with Richard Froyen) with Edward Elgar (http://www.e-elgar-economics.com/bookentry_main.lasso?id=12510). This graduate-level text provides an overview of the conduct of optimal monetary policy in different modelling frameworks. Alfred's current research focuses on analyzing theoretical issues such as optimal monetary policy from a timeless perspective in

an open economy framework, the attractiveness of price-level targeting in an open economy, and the need for distinguishing between instrument and targeting rules in the conduct of monetary policy. Primarily empirical issues are addressed in papers dealing with the implementation of monetary policy in New Zealand. Other research interests extend to a variety of topics: the sustainability of current account deficits, the term structure of interest rates, and the reaction of central banks to asset-price inflation.

Philip Gunby is working on three projects. One is with Michael Wilkinson and consists of assessing the the 2001 HSEA occupational safety and health amendments. Another project is an offshoot from work done in the past with three European co-researchers on the economics of learning from technological disasters and investigates the diffusion of learning from technological disasters. He also has a long-term project begun with colleague, Alan Woodfield, on the economics of education. Their work involves investigating the information schools provide to parents when they compete for students. Some of the work, mainly in building up a database, has been funded by the Zealand Institute for the Study of Competition and Regulation in Wellington.

Robin Harrison is currently working on the determinants of variations in the aggregate NZ share price time series index in terms of demographic and macroeconomic changes spanning the last two decades. This is a joint study with Samanthala Hettihewa using econometric analyses to estimate vector equilibrium correction mechanisms and the long run relationships between the multivariate time series. A second project is to investigate the robustness of econometric estimates of the impacts of school zoning restrictions on house prices in Christchurch.

Stephen Hickson is a Senior Tutor. His research interest centres around economic education at tertiary level. He is currently researching, with Bob Reed, whether or not written answer questions in invigilated exams add any information to that already captured by multiple choice questions.

Seamus Hogan's research mostly involves topics in applied microeconomic theory. He is currently working in three main areas. First, models of monopoly behaviour when some buyers have access to a parallel currency such as airmiles or the currency of a local exchange trading scheme. His second area of research interest is the New Zealand electricity market, and the effect that the separation of the market into generation, transmission, and distribution but with vertical integration has on electricity prices. Finally, he has a paper deriving a new uniqueness condition for continuous (oligopoly) games.

Andrea Kutinova currently does research in the economics of infant and child health. Her work uses both economic theory and empirical methods and focuses on New Zealand as well as international issues. Her ongoing projects include:

- An evaluation of midwifery services in New Zealand. (About 80% of NZ deliveries are fully administered by a midwife as compared to around 8% in the U.S. and many European countries. This is partly due to public policies of the 1990s favouring midwives.);
- An analysis of the effects of unemployment on fertility rates in New Zealand (with Joanne Laban) and on prenatal behaviour and birth outcomes in the U.S.; and
- A grant proposal to evaluate hearing screening protocols for young children to be implemented in the new B4 School child check.

Phillip Meguire thinks and writes about three topics:

- Law and Economics. Property rights and tenure review in South Island pastoral leases.
- Philosophy. Tenure review may unwittingly implement a bastardized version of the Lockean theory of property. The recent theories of social norms and the law, advanced by Ellickson and Eric Posner, may have much to contribute here.
- Mathematics. For an example, consult http://en.wikipedia.org/wiki/List_of_algebraic_structures

Laura Meriluoto, together with B. Curtis Eaton from University of Calgary and Ian MacDonald from Lincoln University, has three ongoing research projects. The first project investigates solutions to spam and the problems associated with these solutions. The research examines filtering, sender-pays pricing and receiver-pays pricing as potential solutions to the spam problem. The second project investigates price competition of spammers who sell identical goods and the effect of that competition on the incentive to spam. The third project analyses existence advertising and the resulting price equilibrium in a duopoly setting.

Les Oxley's research continues to have several themes. His current Marsden funded research with David Thorns, Ken Carlaw, Paul Walker and Hong Wang focuses on "Winners and Losers in the Knowledge Economy/Society". What is new and what is hype in this area was the focus of a recent MOTU-sponsored seminar in Wellington. Cliometric research is alive and well in New Zealand and ongoing work here by Les includes joint work with David Greasley on i) "The Pastoral Boom, the Rural Land Market, and Long Swings in New Zealand Economic Growth 1873-1939" and ii) "Patents as a measure of inventiveness". Collaborating with Kris Inwood, NZ anthropometrics has also been given some life using records from WW1 soldiers to consider, "Physical wellbeing and stature in New Zealand." In the more 'mainstream' time series econometrics area, Les is currently working with Marco Reale and Granville Tunnicliffe Wilson on "Graphical models for sparse structural vector autoregressions"; Eduardo Mendes and Marcello Medeiros on "Nonlinear cointegration with stationary transition variables"; with Eduardo Mendes and Marco Reale, on "Some new approaches to forecasting the price of electricity"; and Bill Rea, Eduardo Mendes and Marco Reale on "Realized volatility: Long memory or shifting means?" In his spare time Les organises conferences.

Bob Reed's main area of research has to do with measuring the effects of taxes on the economy. His work focuses on U.S. states, which supply a good "laboratory" for studying tax effects. Within this broad area, there are several sub-areas in which he is working: (i) Using state-level, political party variables as instruments to address endogeneity bias; (ii) Procedures for separating the effects of marginal from average taxes; and (iii) Consequences of alternative econometric procedures (such as mean pooled regression) for estimating tax effects.

Another line of research has to do with related econometric issues: (i) How should one choose the "best" regression specification, (ii) A comparison of the performance of alternative panel data estimators, and (iii) A bootstrapping procedure to use with panel data estimators characterized by both cross-sectional correlation and serial correlation.

Maroš Servátka specializes in experimental and behavioural economics, and is interested in how social norms and fairness considerations govern decisions of economic agents. Currently, he is working on a paper examining whether informal agreements, such as *Handshakes*, foster trust and cooperation in the absence of written contracts (co-authored with Martin Dufwenberg and Radovan Vadovi). His other projects include a study on whether agents can achieve more efficient outcomes through *Trust signalling* (with Steven Tucker and Radovan Vadovi), an experimental comparison of the effectiveness

of cheap talk promises and costly deposits in increasing trust and trustworthiness (*Put your money where your mouth is*, with Steven Tucker and Radovan Vadovi), and experiments on *Imperfect monitoring and small prizes in team production* (with Carsten Schmidt).

Steven Tucker is currently working on numerous projects employing the methodology of experimental economics to study questions in Behavioral Economics. Two of these projects are focused on examining transactions involving trust and trustworthiness. The first paper, *Trust Signaling*, studies the welfare implications of the strategic use of trust and provides evidence for the evolution of predominantly sequential institutions for these types of transactions. The second paper, *Put Your Money Where Your Mouth Is*, studies the effect of allowing for pre-interaction cheap talk and/or monetary deposit as mechanisms to increase trust and trustworthiness. A second area of interest is bidding behavior in auctions in which he has two papers, *Experimental Investigation of Overdissipation in the All Pay Auction* and *Experimental Investigation of Individual Bidding Behavior in the All Pay Auction*, studying behavioral explanations for aggregate and individual overdissipation of rents in all pay auctions. He also has interests in the bidding behavior in laboratory asset markets, and his current paper, *An Experimental Study of Bubble Formation in Asset Markets Using the Tatonnement Pricing Mechanism*, examines whether the extremely robust result of bubble formation in these asset markets may be a result of participants incorrectly viewing themselves at price takers. His third area of interest addresses cultural factors that may lead to different economic decision making between Chinese and the West. The first paper in this area, *An Experimental Study of Endogenous Comparative Advantage and Cross Cultural Implications of China and US*, is a study possibly foreshadowing future changes to trade interaction between China and the Western economies. The second paper, *Private Provision of Public Goods in China*, examines differences in effectiveness between formal and informal sanctioning mechanisms within Chinese cultural. Finally, he is starting a new research agenda on insurance contracts. More specifically, he will be analyzing people's ability to choose insurance contracts optimally, fraudulent behavior associated with insurance contracts, and mechanisms to reduce the incentives of fraudulent behavior and therefore increase overall welfare.

Richard Watt's research interests are in the field of applied microeconomic theory, with special interest in the specific topics of the economic theory of risk bearing and insurance, and the economics of copyright. He has several on-going research projects. In the field of the economics of insurance, he is working on issues relating

to bonus-malus in insurance, and also working on setting up an experimental study of insurance fraud. In the field of copyright, he has been writing a survey paper, and is now interested mainly in looking at the robustness of the copyright protection standard used in developed countries when applied to developing countries. The methodology will be to look at the comparative statics of optimal copyright with respect to income and wealth.

Alan Woodfield is currently working on three projects. First, he is working with Philip Gunby on a long term investigation into the determinants of the levels and composition of informative and promotional advertising expenditure in a panel of Christchurch secondary schools. This research is supported by ISCR and the College of Business and Economics at Canterbury. The most recent work develops a Perfect Bayesian Equilibrium approach to the decision by schools as to whether or not to acquire and disclose value added performance information, and whether regulators should either enforce or prohibit acquisition and disclosure. Second, in conjunction with Andrea Kutinova, he is examining the determinants of sentencing severity for successfully prosecuted charges relating to the Health and Safety in Employment Act in conjunction with the Sentencing Act. Finally, he is investigating theoretically and (hopefully) empirically a policy whereby enforcement resources are specialized in monitoring the safety standards mainly of "high-risk" employers and sectors where penalties for breaches of statutory standards exist even in the absence of accidents. []

THE PUBLIC INTEREST

"...the public interest is a public good. Since the efforts to maintain a good government must come from private individuals, there will be an undersupply of this (as any other) privately provided public good."

P.144 of Stiglitz, J. E. (1986). *Economics of the public sector*. New York: W.W. Norton.

But note that this does not mean that government will be too small. Given imperfect information, manipulated preferences and the interests of politicians and bureaucrats, there may be an oversupply of public sector activity (because people do not invest enough in monitoring and constraining government).

Every generation has its own popular delusions – what are ours?

Over 150 years ago, Charles Mackay wrote *Extraordinary popular delusions and the madness of crowds*. The introduction to the 1995 publication of the text was written by Norman Stone, Professor of Modern History at the University of Oxford. In it he wrote:

Throughout the world people have tended to focus on individual issues rather than on the good of society as a whole...frequently the zeal with which campaigns are conducted damages the causes they are meant to promote...The examples are numerous, disturbing and may seem peculiar to our age. Surely they managed things better in the past? Well no, they didn't. Of necessity, the oddities of our age are peculiar to it, but more in detail than extent...human folly changes only in detail and not in scale. (pp.v-vi)

And in the Preface to the 1852 edition, author Charles Mackay wrote:

In reading the history of nations, we find that, like individuals, they have their whims and their peculiarities; their seasons of excitement and recklessness, when they care not what they do. We find that whole communities suddenly fix their minds upon one object, and go mad in its pursuit; that millions of people become simultaneously impressed with one delusion, and run after it, till their attention is caught by some new folly more captivating than the first. (p.xv)

Mackay, C. (1995). *Extraordinary popular delusions and the madness of crowds*. Ware: Wordsworth Editions.

NEW ZEALAND ECONOMIC PAPERS

Ananish Chaudhuri, the editor of *New Zealand Economic Papers*, invites members to submit their papers to the journal. In keeping with tradition, papers in all economic subject areas will be considered, and papers covering New Zealand topics are particularly encouraged. See also the special announcement on the previous page.

Offers and ideas for symposia of papers on particular topics are also welcome.

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For more details, go to:

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NEW MEMBERS

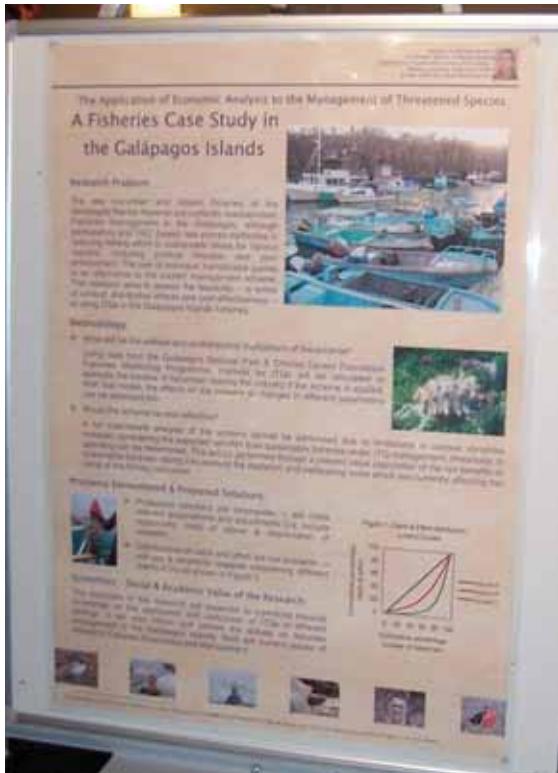
Welcome! to the following people who have recently joined NZAE...

Nathan Penny (NZ Treasury); **Andrew Johnson** (NZ Treasury);
Andrew Coleman (Reserve Bank); **David Norman** (BERL);
Fiona Stokes (BERL); **Dallas Welch** (Statistics NZ);
Andrew Fung (Inland Revenue Dept.); **Simon Carruthers** (Waikato University); **Jamie Legge** (Families Commission);
Daniel Evans (Barter Software).

WEB-SITE

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