AUSTRALIA'S OUTLOOK FOR POLITICS AND GOVERNMENT IN 2010

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After the tumultuous events in Canberra last week, it now seems clear the next federal election will be a double dissolution held not much earlier than normal - late September - with climate change and Work Choices as its main issues. It also seems likely that Kevin Rudd will win in a landslide.

Mainly through over-reach, Mr Rudd has managed the most remarkable wedge of his opponents, driving a huge divide between the party faithful and the wider electorate. The polls show majority support for an emissions trading scheme, even among Liberal voters. The only respect in which that support wavered was on the question of whether it needed to be approved before Copenhagen. The polls show no evidence of growing disapproval of an ETS, suggesting that all the emails and phone calls flooding into Liberal members' offices insisting the ETS be blocked were coming from the party faithful, whose main motive was distrust of anything proposed by Labor, and so were quite unrepresentative of the wider electorate.

The Liberals

So the party that lived by the wedge while in government is now dying by the wedge while in opposition. The distinction, however, is that whereas Labor always ended up spurning its heartland in favour of the wider electorate, the Liberals have chosen to go the other way. Mr Rudd has positioned Labor slightly to the right of centre, and now has succeeded in pushing his opponents further away from the middle ground.

Tony Abbott won the Liberal leadership by accident. Polling before the leadership contest revealed him to be the least popular among the three contenders. The majority intention within the parliamentary party was always to pass the job to Joe Hockey, but that didn't happen, mainly because of his ambivalence towards taking the job before this election and because of his reluctance to repudiate his support for the ETS. Some in the party have charged Mr Hockey with being indecisive, but I think he's been fortunate and is now well positioned to take over the job from Mr Abbott when the party tires of him, as seems inevitable. Mr Abbott is an immensely likeable person in the flesh, but few voters will get to meet him in the flesh. As his very first days in the job demonstrate, he'll be incapable of concealing his extreme views on social issues and quite conservative views on issues such as individual contracts, unfair dismissal and nuclear power. This expression of his views in advance even of the selection of his shadow cabinet suggests he's unlikely to be more consultative than his predecessor. Some politicians do change their spots when they attain high office, but I doubt if Mr Abbott will. The pollster Rod Cameron has branded him 'unelectable' and I'll be surprised if the election results don't bear him out.

Mr Abbott has made it clear he intends to be a lot more obstructionist than Malcolm Turnbull was, opposing almost everything the Government tries to get through the Senate. The Opposition is so divided that that just about the only thing it can agree on is hatred of the Labor usurpers. This sentiment is shared by its party faithful, so they too will be gratified. But more pragmatic opposition leaders don't let through a lot of government legislation because of a sense of public duty, they do it because they know the electorate hates obstructionism and negativity in its politicians. Once again, the Libs will be preaching to the choir, not the unconverted.

It's worth remembering that the hardliners in the parliamentary party tend to be senators and people with very safe seats, whereas the moderates who supported Mr Turnbull and wanted the ETS passed and out of the way tend to have marginal seats. So if the party suffers a significant loss of seats at the election, this will tend push it further to the right. Perhaps that could save Mr Abbott after all.

The ETS legislation

Don't be in any doubt about the status of the ETS. The Government has made clear it remains committed to getting it passed as amended by the agreement with Mr Turnbull. Once you've conceded ground to the rent-seekers, there's no going back. And that means Mr Rudd, who <u>must</u> have a scheme, has no choice but to call a double dissolution. There's no way the Liberals will agree to any ETS , and since there's no way the Government will gain a majority in the Senate at the next election, its only hope of getting the bill passed is at a joint sitting after a double dissolution. Whether or not the election is a double dissolution, it seems likely the balance of power in the Senate will shift to the Greens in their own right. So were the Government simply to try its luck at getting the bill through the <u>next</u> parliament, it would have to throw out all the concessions it has granted to business and move the scheme in entirely the opposite direction, an utterly unattractive prospect for Mr Rudd.

The Double Dissolution

However, Mr Rudd has no desire to pull on a double dissolution <u>early</u> next year for several reasons: it would clash with state elections in South Australia and Tasmania on March 20; it would put the two houses out of kilter and thus truncate the next term by about a year; it would give Mr Abbott too little time to blot his copybook, and finally because modern politicians seem genuinely reluctant to risk annoying the electorate by calling early elections.

The Government has announced its intention to bring the <u>amended</u> bill back into parliament in February, even though it's highly unlikely to be passed. It has left the press gallery with the impression it will then wait three months and put the bill up to be rejected again. This <u>new</u> trigger, it says, would allow it to take the amended bill to the joint sitting rather than the original bill. But I understand the constitution allows it to amend the bill at a joint sitting, so its true motive is probably just to delay the double dissolution until later in the year, for the reasons I've given.

For constitutional reasons, the Government is unlikely to want to hold a double dissolution election before July 1, but it must be called before August 10. This suggests the most likely time for the election to be held is the second half of September - which wouldn't be considered particularly 'early' by most people.

It's not always the case that the rejected bills that provided the trigger for a double dissolution rate much attention in the election campaign, but I have no doubt the ETS will be a key issue in this campaign. The Opposition will run a scare campaign about Labor's 'big new tax' and Labor will have to explain and defend its scheme. But Mr Abbott's and Julie Bishop's inability to stop themselves speaking in defence of individual contracts and unfair dismissal will leave it open for Labor to run its own scare campaign about the return of Work Choices. If I'm right, the 2010 election campaign will be fought on the same two policy issues that contributed most to the Liberals' defeat in 2007 (apart from the it's-time factor). Remarkable.

Rudd's over-reach

On the face of it, Mr Rudd has brilliantly wrong-footed his opponents, almost guaranteeing they'll perform poorly at the election - and maybe the one after that. But I think it got out of control and he over-reached himself, damaging his opponents more than he intended to and failing to achieve various of his objectives. For a start, he failed to get through legislation he could boast about at Copenhagen. He further debauched his ETS at a cost of $7 billion but has nothing to show for it; he's lumbered with a double dissolution he pretty clearly didn't want, he's facing a more obstructionist Opposition between now and the election, and has to fight the election trying to counter an almighty scare campaign about 'a big new tax,' a prospect he doesn't relished.

Although he can't avoid a double dissolution if he wants his ETS, it has costs. Because they halve the quota of votes needed to be elected, double dissolutions favour minor parties and disadvantage the major parties in the Senate. Labor's expected to make a net gain of only one Senate seat; Mr Rudd might have done better than that in an ordinary half-Senate election. The number-crunchers expect Senator Fielding to disappear but be replaced by some other independent, and Senator Xenophon to gain a running mate. The Greens would have gained the balance of power in their own right in a half-Senate election, but a double dissolution will give them even more seats.

Mr Rudd was playing politics with policy. Despite agreeing to special concessions earlier this year that made a complex policy even more so, he long ago stopped explaining and defending the ETS, preferring all the attention to be on the brawling Coalition. He did nothing to counter the alarm being spread by Barnaby Joyce and Alan Jones, nor to refute the self-serving exaggerations of various industry lobbies. He allowed the ETS to be further perverted to provide Mr Turnbull with the cover he needed to be able to support the bill, leaving unchallenged the fiction that it was 'deeply flawed' but had now been improved to 'save tens of thousands of jobs'. But in his desire to have the world watch the Liberals tearing into each other he over-reached, undermining Mr Turnbull by failing to counter the propaganda spread by Mr Turnbull's opponents in the Coalition, and thereby allow opposition within the Coalition to grow to the point where Mr Turnbull was overwhelmed.

The invisible recession

At this conference two years ago, the greatest problem of the newly elected Rudd Government was that it had won office at a time when a recession was overdue and, with the economy travelling near full employment and the Reserve Bank vigorously applying the brakes, it was facing a high likelihood of recession some time in its first term. At this conference one year ago, after the culmination of the global financial crisis with the collapse of Lehman Brothers, it looked certain we were facing a severe recession, but one that could easily be blamed on forces beyond the Government's control. Kevin Rudd was off the hook: don't blame me, it's the GFC.

What a lot has changed in 12 months. Today, after the application of huge fiscal and monetary stimulus, we're emerging from a recession so mild the public can't see that we had one. So the old business cycle has been completed and a new one begun with only the most moderate collateral damage. Through a combination of good luck and good management - its own and its predecessor's - the Rudd Government is home scot free: it's presided over a recession as feared, but one that generated little pain and no blame. The one small risk is that, as memories fade, the whole thing may come to be regarded by some as a Government beat-up: a lot of carry on about nothing. Such forgetfulness would strength the Opposition's claim that Rudd has gone on a pointless spending spree leaving nothing to show but huge deficits and debt that will burden our children and grandchildren. The fear of government debt does have some potential to worry the economically unsophisticated, but its potency is greatly diminished by the Opposition's general lack of credibility. The fading memory of the cash splashes and the likelihood of further interest rate rises next year won't help Labor's re-election campaign, but they're unlikely to represent a significant problem to a government that remains so popular.

The painless Prime Minister

A further year to observe Kevin Rudd has served only to deepen my disappointment in him and confirm the reservations I expressed last year. He's a much more skilful - that is, cynical - politician than most of us realised, but he's no great reformer and, thus, no great leader. He's a weak leader, lacking ideology and conviction apart from his unquenchable desire to stay in power. Combine his lack of commitment to particular policy reforms with his preoccupation with political objectives and you understand his reluctance to do anything that imposes pain on anyone and thus could threaten his popularity.

In his unconscious mind he's still in opposition, ready to throw overboard any mildly unpopular policy that could stand between him and (re-)election. Perhaps because of his success with the recession, and partly because of his frenetic pace of activity, it's yet to occur to him that governments get judged by their achievements, rather than their busyness, and that to get truly memorable achievements up and running involves taking risks and putting noses out of joint. John Howard understood this with his determination to introduce his two cherished reforms, the GST and Work Choices. He almost lost an election over the GST and he only pulled back from the full-bore Work Choices when he realise how deeply unpopular it was with Howard's Battlers. It's too early in Mr Rudd's career as Prime Minister for it to have occurred to him that, unless he gets some genuine reforms into place, he risks the same judgment made of Malcolm Fraser: he managed to stay in power for X years, but is there to show for it? A leader who lacked the courage to lead, who was only ever prepared to use his credit points to secure his re-election, never to buy reform.

Mr Rudd is no economic rationalist because he simply hasn't absorbed 'the economist's way of thinking'. From his chronic inability to set priorities or to delegate you see he has no inherent conception of opportunity cost. He has no inbuilt suspicion of interventionist solutions. Combine this with his lack of ideology - his dearth of prior beliefs about how the world works and should work - and you see the best label for him is that he's a 'pragmatic interventionist'. He is pro-business rather pro-market, seeing economists as just another interest group to be propitiated from time to time. He is keen to ensure business remains generally on side, so interest-group appeasement is a major part of his modus operandi.

From his utterances he has an ambivalent attitude towards economic rationalism, blaming 'neo-liberals' for the global financial crisis and accusing his Liberal opponents of being neo-liberals, while claiming the credit for Labor for all the Hawke-Keating government's microeconomic reforms. He also claims to have instigated an extensive program of micro reform himself through COAG, involving '27 regulatory reform agendas, covering areas such as financial regulation, consumer protection, trade licences, food regulation, occupational health and safety, and chemicals and plastics laws'. Most of this involves answering the call of big business for a 'seamless economy' through the reduction of differences between the states. It's true that a huge program has been initiated, but it's also true that negotiations have bogged down and little progress has been made in two years, partly because the prime ministerial caravan has moved on to other, greener fields. Mr Rudd loves the grand gesture - signing the Kyoto protocol, apologising to the Stolen Generations, announcing 'the most comprehensive [Defence review] of the modern era', promising to rebuild the Victorian bushfire towns 'brick by brick, school by school' and to be there with these communities in 'the months and years that lie ahead' - but so far always falls down on the follow-through.

Much has been made of Mr Rudd's policy wonkery and commitment to process, but there's precious little of value to show for it. The truth is that, because of his inability to set priorities and delegate, his interest in every policy consideration hasn't improved the quality of decisions. Rather, his obsession with personally approving every detail has produced a behind-the-scenes shambles, where decisions pile up waiting for his attention, unreasonable demands are made on public servants, everything runs late and policy elements are thrown together at the last minute. While Mr Howard kept a tight rein on policy decisions, he didn't usurp the role of his ministers the way Mr Rudd does. The cabinet has become a rubber stamp for decisions made by Mr Rudd's kitchen cabinet, the Strategic Priorities and Budget Committee, composed of himself, Julia Gillard, Wayne Swan and Lindsay Tanner. There are even suggestions that the other three merely get to comment on the propositions Mr Rudd brings to this committee.

It's become much clearer that it's politics Mr Rudd is on about, not good policy. Presumably, much of his obsession with detail is directed to getting the politics right. Smart leaders try to starve their political opponents of oxygen by purporting to ignore them; Mr Rudd can't resist criticising and baiting his opponents at every opportunity, often with a phony appeal for bipartisanship. What he doesn't seem to have realised is that by debating the Opposition's criticisms, he brings them more media attention than they'd otherwise get. Hence the seriousness with which the press gallery has taken the Opposition's carry-on about deficits and debt, and the ill-informed claim that the planned fiscal stimulus needs to be curtailed.

Mr Rudd is even more obsessed with dominating the 24-hour news cycle than Mr Howard was. The motive is to keep the initiative away from the Government's critics, give the appearance of ceaseless devotion to duty and keep the media so busy they don't have time to hunt out their own stories - such as why promises haven't been kept or why policies aren't delivering. The main instrument is to produce a continuous stream of (usually pretty minor) 'announceables'. The price of this media management is that it wastes the time of bureaucrats, distracts the attention of ministers and gives spin doctors primacy over policy wonks.

Mr Rudd is not a Labor animal. He has no powerbase within the party, no union links (or much sympathy with unions), no great factional support and no mates. His undoubtedly strong support within the party at present is based purely on his political success; he enjoys little affection or loyalty. But even on this he is stretching the forbearance of his party with his delight in giving jobs to the Liberal boys. At one level this is a clever political tactic, wrong-footing his opponents and increasing his apolitical appeal to wayward Liberal and swinging voters. It's saying: I can't be such a bad manager if all these big-name Liberals are happy to work for me. At another level, however, it's storing up trouble for the future. If your modern Labor politician is, like Mr Rudd himself, less driven by a desire to implement traditional Labor policies and more attracted to attaining and enjoying the spoils of office, then Mr Rudd is advancing how own enjoyment of power at the expense of his underlings' advancement. It's something they will remember when the day comes that Mr Rudd loses his winning touch. The other point is that his willingness to appoint people whom he has criticised so heavily in the past, and the alacrity with which they accept the offer to work for a Government they have branded as incompetent, exposes the phoniness of much political rhetoric.

Rudd Government's second year

Mr Rudd's first year involved the commissioning of a huge number of inquiries; his second year has involved the receiving of many of those reports without many decisions about implementing their recommendations. So far there's been a lot of talk and a lot of spending, but not much reform.

A few weeks back Lindsay Tanner offered a list of reforms in which, he said, 'substantial progress has been made'. His list included: developing a national trade licensing system, improving processes in the regulation of the construction industry, improving environmental assessment and the development of a national construction code.

Of course, you could argue that for much of the year the Government had its hands full responding to the global financial crisis. I think it did a very good job on this, not just in the alacrity and Treasury-provided skill with which it applied fiscal stimulus, but also in the cleverness with which it managed business and consumer confidence - a key element in making the recession so mild. Oppositions have to find things to oppose, but I suspect an element in the Opposition's disapproval of the fiscal stimulus was resentment that Labor had used the good budgetary position it inherited from the Libs to spend a lot of money and buy a lot of popularity in the name of staving off recession.

There's something in this. If you look carefully at the stimulus packages you see tell-tale signs of political as well as economic calculation. The first cash splash, for instance, was supposed to be aimed at those welfare recipients so credit-constrained that they were highly likely to spend all the cash without delay. How then do you explain the decision to exclude people on unemployment benefits from the bonuses, while including self-funded retirees? Political considerations explain it easily. Dole recipients were also left out of the second cash splash. And what about the decision to build a new building at every primary school in the country, whether public or private? It can be readily defended as spreading the stimulus to the building industry far and wide, but consider the political attractions.

This year's budget wasn't bad, but wasn't particularly good. Its main measure was an excessively generous increase in pensions. This seemed largely politically motivated because age pensioners are hardly the most needy welfare recipients, and steps were taken to limit the flow-on to the more needy but less politically powerful sole parents and people on the dole. This measure was hugely expensive, with the cost growing each year forever. True, this cost was largely offset by five measures - including the phasing up of the age-pension age, and the cutbacks in salary sacrifice for superannuation - which could be classed as reductions in middleclass welfare. Well done. Only problem is, whereas these reforms could have been used to undo some of the spending and tax-cut extravagance of the Howard years and thus help get the budget back into surplus, they were in a sense ‘wasted’ on helping to pay for a new extravagance of the Rudd Government.

The year ahead and tax reform

Aside from the election, the two big economic issues for 2010 will be the budget and the Government’s response to the report of the Henry taxation review. Despite the imminence of the election, I expect the budget to be a restrained affair, with any new spending programs covered by savings elsewhere. Total government spending in 2010-11 is likely to fall in real terms - for the first time in 20 years - because of the planned withdrawal of stimulus. The Government will have a terrible struggle to achieve its commitment to limit its real spending growth to 2 per cent a year, but not in the election year.

Turning to the tax review, although it’s due to report to the Government before Christmas, the Government isn’t likely to make its report public until February or March next year. Even so, we have an idea of what to expect.

The report is intended to lay out a blueprint for the direction of reform over the next 25 years, to act as a guide to governments in their day-to-day decision-making. Would some particular decision move us towards or away from the ideal destination we are hoping to reach eventually? So although the report may include some popular proposals the Rudd Government could implement before the 2010 election, and some which it could promise to implement in its second term, it will also contain controversial proposals the Government is likely to disavow. This was the initial fate of the Asprey report of 1975, which included such obviously politically impossible recommendations as the introduction of a capital gains tax, a fringe benefits tax, a dividend imputation scheme and even a goods and services tax. Dr Henry is hoping to produce the next Asprey report.

As always, the report will focus on improving the pursuit of the three objectives of good tax design: efficiency, equity and simplicity. But it will be looking for reforms that, while increasing allocative efficiency, can also be advocated as increasing fairness. For instance, the 50 per cent discount on the tax on capital gains can be criticised as distorting taxpayer choices, but it can also be criticised as unfair because such a high proportion of all capital gains are enjoyed by a handful of high income-earners.

Often, simplicity is the objective that loses out in the effort to find better trade-offs between equity and efficiency. But not this time. Dr Henry has long been concerned about the growing complexity of the tax law and the greater risks this generates for those (generally poorer) taxpayers who lack access to good advice. He is determined to strike a blow for simplicity, which he believes will also increase fairness. A major gain for simplicity would be achieved if, rather than continuing to have to run to the expense of paying a tax agent to prepare their annual tax returns, most people were able to submit a pre-filled return just with a few clicks of a mouse.

The great workhorse of tax reform is the maxim: broaden the base to cut the rate. So we can expect to see plenty of examples of the report proposing that exemptions and special deductions from a particular tax be reduced so as to finance a general reduction in the rate of the tax. Both sides of such a reform could be expected to reduce the tax's distortion of producers' and consumers' choices. One example could be rationalising the differing rates of tax on different forms of alcohol, without that leading to any increase in overall receipts from alcohol taxes.

Until now, a guiding principle of tax reform has been the ideal of 'comprehensive income taxation'. This is the notion that a dollar of income is a dollar of income, so it should be taxed at the same rate regardless of how it is derived - from work, profits, dividends, interest, rent or capital gain. Sometimes the comprehensive ideal is seen in terms of <u>nominal</u> income but, it should really be based on real income - meaning that allowance should be made for the inflation-compensation component of interest income and capital gains. However, Dr Henry has noted that the comprehensive income ideal has fallen out of favour with tax economists around the world, implying that it will be abandoned in the report in favour of a dual tax system, where there is one rate scale for earned (work) income and a different one for investment income.

In any case, the comprehensive income tax ideal has, in practice, been honoured in the breach. Income from the different ways of saving is taxed at radically different rates because of a multitude of special arrangements. Dr Henry calculates that, at present, for a middle income-earner on a nominal marginal tax rate of 31.5 per cent, the real effective marginal rate of tax is minus 40 per cent for saving through superannuation, zero for saving through paying off owner-occupied housing and plus 54 per cent for saving through bank accounts. The tax rate on saving through ownership of rental property is plus 24 per cent if the property is owned outright, but minus 22 per cent if negatively geared. The tax rate on saving through listed Australian shares is plus 10 per cent if the shares are owned outright, but minus 35 per cent if negatively geared. I doubt if Dr Henry would be pointing to these hugely anomalous results if he wasn't intending to propose that something be done about them.

The report is likely to recognise the need to ensure Australia attracts sufficient foreign investment to meet its continuing investment needs, but seems likely to recommend only a small reduction in our present company tax rate of 30 per cent. It may recommend an increase in the resources rent tax on mining companies.

On superannuation, where the present concessional taxing arrangement greatly favours those on higher marginal tax rates (that is, those who already have the greatest capacity to save), the report is likely to recommend arrangements that redirect more of the tax benefit to those on lower marginal rates. It may also propose phasing up the age at which people are able to access their super savings from the present 55 years (with the ability to receive benefits tax free at 60 years) to align with the recent decision to phase up the age for age-pension eligibility to 67.

With the cut-in point for the top personal income-tax rate of 46.5 per cent having been lifted to $180,000 a year - so that now only 2 per cent of taxpayers are subject to the top rate - the report is not likely to recommend the top rate be lowered.

The report will also recommend reform of state taxes. It may propose that steps be taken to harmonise the tax bases (including tax-free thresholds and exemptions) and possibly rates between the states. It is unlikely to propose the abolition or reduction of payroll tax - which is essentially similar in its effects to the goods and services tax - although it may propose national harmonisation, with a lower tax-free threshold in exchange for a lower tax rate. The report may recommend the removal of stamp duty on insurance policies, but it won't recommend removal the of stamp duty on property conveyancing for as long as the family home remains exempt from capital gains tax.

Finally, Dr Henry is very concerned about environmental issues and the need to internalise to the price system the external costs of environmental degradation. To this end, it seems clear he will propose the introduction of graduated road user charges - congestion pricing - to replace fuel tax and registration fees.

Observations on monetary policy

It's been another bad year for business economists and markets in their attempts to second-guess the Reserve Bank's rate adjustments. It was a year in which people forgot a lot of the Reserve-watching rules we were supposed to have learnt a long time ago. Most people spent most of the year on the wrong tram in terms of their expectations, even though they were switching trams. People spent the first part of the year expecting a lot more easing than eventuated, then the second part expecting more tightening than eventuated. People have trouble picking the turning points - the point where easing stops and then the point where tightening starts, or vice versa - but then when they finally pick up the new trend they go overboard and get the pace wrong, expecting a lot more a lot sooner than eventuates.

A big part of the trouble the market has interpreting the Reserve's utterances arises from its self-absorption. It interprets the Reserve's remarks from its own perspective rather than the perspective of the speaker. Because the market is always forward-looking, it assumes that when the governor talks about not being 'too timid to lessen the stimulus in a timely way' he must be talking about the future, when, being a bureaucrat concerned with explaining and justifying the recent decision to get on with lessening the stimulus (a move some business economists criticised as premature), he was talking about the past. The market may be focused on the future, but bureaucrats find it much easier to talk about what they've done, rather than what they intend to do. In that particular episode, some people were saying that by <u>next</u> month the case to start tightening would be clear, but if it was already that close to being clear, why wait? The board didn't.

Having said that, I have to add that the Reserve is far from adept at sending clear signals to the market. As a professional communicator I have a simple rule: if the punters take the wrong message from what you say, it's always <u>your own</u> fault. You'd think the Reserve would have learnt by now that its backward-looking self-justifications were often taken to be hints about the future and would know to label those justifications more carefully.

But there's also inconsistency in the Reserve's behaviour. For some months it kept repeating that its reduction of monetary stimulus would be 'gradual', but its action last week in making an unprecedented three rate rises in a row leaves me at a loss to know what meaning it intended us to attach to the word 'gradual'. Was it just a signal that it didn't intend to tighten in steps of 50 or 100 basis points? I suspect the truth is that, for reasons undisclosed, it decided to throw 'gradual' overboard.

Turning to the outlook for 2010, the Reserve will be seeking to manage the economy in a new expansion phase. Earlier this year, when the governor was seeking to prepare people for the commencement of a new tightening phase, he spoke often of the need to start moving the stance of policy 'towards' neutral, but the media usually reported this as 'to' neutral. There's an important distinction between 'towards' and 'to'. But whether that distinction will turn out to have any content I wouldn't be sure.

Since the Reserve will be responding to the data as they roll in - and this year has reminded all of us how appallingly bad we are at predicting what data will roll in - it's certainly possible that, by this time next year, the stance of policy will be back to neutral or even on the tight side. But for this to happen, the economy would need to be growing very strongly - well above trend - and underlying inflation's return to the middle of the target range would have to have faltered.

Last year I observed that when interest rates are a long way from neutral - in either direction - you probably shouldn't stay there for long. I think this attitude has been an important part of the governor's thinking this year, as reflected in his references to the need to end the emergency setting of rates now the emergency has passed. Against this, you might have thought that when he judges the emergency component to have been withdrawn he would pause for some months while deciding when he judges a continuation of the tightening to be warranted. But whether the Reserve ends up sticking to this logic is anyone's guess.

As rates rise during the year the question of just where neutral is will become more important and it's possible the Reserve will feel the need to offer more guidance on the question than it has. So far, the governor has declined to nominate a figure, except to say that the long-run average cash rate is between 5 and 6 per cent. I usually take this to mean the neutral rate is 5.5 per cent, near enough, but there's an argument to say it should be lower than it was if the banks' spreads above the cash rate are higher and credit standards are more demanding. Trouble is, there's another argument to say it should be higher than it was if faster population growth and unusually high rates of investment spending have raised our potential growth rate. This leaves me thinking the two arguments probably pretty much cancel each other out, leaving neutral remaining near enough to 5.5 per cent. We can expect to hear more such speculation as next year progresses.

And as the year progresses many observers' minds will be exercised on the question of how the approach of the election will affect the timing of rate rises. My guess is that this question will exercise the observers' minds more than it does the governor's. He's already said he knows of no convention that monetary policy should not be adjusted during election campaigns. Mr Stevens is a very straight shooter. He doesn't play political games and his idea of being apolitical is to focus on doing his job as normal and make sure no one can accuse the Reserve of failing to do what needed to be done.

Decisions about changing the setting of policy from one month to the next are judgment calls, as much a matter of art as science. This is why, as I've said before, monetary policy is set in the governor's gut. Many people imagine he has a game plan in his head and if only you could know what that plan is you could predict rate movements with great accuracy. I think that was much truer of his predecessor than it is of Mr Stevens. All you can say is that he reacts to the data as it comes in and makes up his mind before or during the monthly meeting.

So if you're going to be second-guessing the Reserve again next year I wish you good luck. You'll have your work cut out and I doubt you'll be getting many reliable signals from the Reserve.