Economists’ contributions to 2\textsuperscript{nd} Great Depression; & what they should learn

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LSE
4 transformations since 1989 generated **optimism** → Crash of 2008

- (1) End of communist bloc, **world-wide adoption of capitalist, private-property-based** system
- (2) Opening of **China & India** (38% world popn) added 3 bn producers/consumers
- (3) **ICTs** installed & deployed in more spaces & sectors, converting globalization from ‘trade globn’ to ‘**production globn**’
- (4) **Paper money + flexible ERs** enabled govts to stabilize macro cycles better
World economy boomed over 2000s

• In West economists & politicians celebrated ‘The Great Moderation’.
• Av growth of DEEs doubled in 2002-08 compared to 1990s. Grew 4-5 pcp faster than high-income ecies, biggest ever gap.
• Boom said to be due to ever more globalization + ICTs. Said to be sustainable in longer-term – good times will keep rolling, ‘this time is different’ (no more big business cycles)
Economics: (1) high impacts on others; (2) 'epistemic asymmetry'; (3) 'epistemic sufficiency'

- Macroeconomists have **high influence** over the life chances of most of world’s population (more than microeconomists, sociologists, anthropologists, pol scientists).
- Macroeconomists operate with high degree of ‘epistemic asymmetry’ (or ‘superiority’) vis a vis ‘the public’.
- They believe their models confer high degree of ‘epistemic sufficiency’ or ‘certainty’ about future-oriented policies. Relevant knowledge is knowledge derived from models.
- **Lesson which should be learned**: Fact that almost no macroeconomist/forecasting organization forecast Crash + Slump indicates fundamental weaknesses in the claims of epistemic certainty and epistemic superiority.
- Economists must learn to be more Humble.
Examples of false confidence

• Anne Kreuger, deputy MD IMF, Apr 2006: ‘the world economy has rarely been in better shape’

• Jean-Philippe Cotis, chief economist, OECD, May 2007: US slowdown not herald worldwide weakness. OECD expects smooth rebalancing “with Europe taking over the baton from US in driving OECD growth.” “Our central forecast remains quite benign... [we expect OECD to show] strong job creation & falling unemployment”.

• Joel Prakken, chair of Macroeconomic Advisers, Sep 2007: the probability of recession is less than 50%
Mainstream economists did not see the elephant in room

- Gary Gorton & Andrew Metrick, “Getting up to speed on the financial crisis”, *J. Econ Lit*, 2012

- “Many professional ecsts now find themselves answering questions from their students [etc.] on topics that did not seem at all central until a few years ago, & we are collectively scrambling to catch up”

- This is a collectively damning statement.
Ecsts’ explanation of why they missed

• November 2008, Queen visited LSE, asked “why did nobody notice it [the coming financial crisis?]”. July 2009, British Academy conference of 33 economists, pol scsts, historians. 3 page letter to Queen.

• **Conclusion**: “the failure to foresee the timing, extent & severity of the crisis & to head it off ... was principally a failure of the collective imagination of many bright people, both in this country and internationally, to understand the risks to the system as a whole”.

• Letter gave no explanation of why they failed.
  
Why mainstream macro economists failed to see it coming: (1)

- (1) Macroecon dominated by ‘mkt fundamentalism’
- “Priors” of mainstream economics:
  - (a) **pre-analytic** belief that ‘market economy’ inherently stable, becomes unstable only exceptionally & temporarily. Modern macro = equilibrium economics
  - (b) Rational choice – EMH
  - (c) Microeconomic takeover of Macroeconomics.
  - (d) Market competition will keep debt within prudential limits; hence “light touch regulation” only.
Where did mkt fundamentaist ‘priors’ come from?

• Late 19C/early 20C neoclassical revolution:
  • Economists wanted to imitate (Newtonian) physics. Gave central importance to mathematical formalization + self-adjusting equilibrium. Individuals = atoms, rats
  • UK & US hegemonic states; their economists reflected own political culture, which celebrated ‘free mkt’ & ‘framework state’
  • European econs (Hayek, von Mises) reacted against Austro-Hungarian empire, Nazi-ism, communism
  • Ecsts took ‘mkt system’ as subject, not ‘capitalism’
Implications of priors for role of state

• Mkts produce efficient allocn of resources, & self-adjust to equilibrium

• State is exogenous. It legitimately ‘intervenes’ in mkts only when ‘markets fail’.

• But state intervention may also fail. In general, probability & costs of ‘government failure’ > mkt failure. Therefore each state intervention & regulation must be justified.
Why mainstream failed: (2)

- (2) **Modern macro treats ‘finance’ as passive;** it accommodates real economy like ‘oil in the engine’. Debt stocks & flows ignored.

- Macroeconomics uses a form of ‘real sector’ analysis as though economy is barter economy, with frictionless & instant transactions. Money is merely a ‘veil’. No credit, borrowing, no debt.

- Therefore modern macro of limited use for understanding movements of interest rates and build up of financial fragility
DSGE models

• Macroeconomics is mostly **DSGE models**
• Based on assumptions of “rational expectations” and “representative agent”.
• Standard DSGE model (used by IMF, OECD, etc.) is Washington University Macro Model: 600 variables, 410 equations, 165 exogenous variables.
• All the variables are real-sector variables, except (1) money supply & (2) interest rate. Values of (1) & (2) assumed determined by real-sector variables.
Macro models – no finance (ctd)

• IMF’s, OECD’s BoE’s macro forecasting models have no financial sector.
• Thereby they disregard inherent mechanisms in Kst economy generating financial fragility (eg Minsky).
• Therefore give little insight into recurring phenomena of Kst financial crises
Why did economists give little warning?

• Economists looked at ‘real economy’ & saw only ‘Great Moderation’ + fast growth in dev’ing ctries
• Govts followed economists’ advice & adopted mkt fundamentalist policies (eg financial deregulation)
• Govts failed to see over 2000s that an ordinary boom-recession cycle was being amplified by (1) housing bubble, (2) stock mkt bubble across western world, causing rapidly rising financial fragility
• This is a strong indictment of economists – because macroeconomics deals with the issues that mass public most care about
But, some ecsts did see crisis coming

• Dutch economist Dirk Bezemer asked: How many analysts foresaw timing of end of boom & severity of recession, & gave analytical account of mechanism?

• 12, including Roubini, Richebacher, Godley, Baker, Hudson, Schiff, Keen... All “heterodox”
Basis of prescients’ forecasts

• They all tracked stocks & levels of debt, on assumption that “finance” sector as real as “real” sector.
• Some used “soft” surveys of consumer confidence & employment.
• Some used “flow of funds” macro models.
• These models allowed them to foresee when relationship b/w finance & real economy turning from supportive to extractive, & when limits of extraction being reached.
• F-o-f models describe interaction b/w balance sheets of: (1) FIRE sector; (2) firms/employers; (3) households/employees/consumers; (4) govt. Track stocks of wealth & debt, flows of credit & debt within & between.
Mainstream justification for ignoring flow of funds

• Mainstream economists long resisted including flow of funds & balance sheets into macro models, on grounds that bubbles cannot be identified in advance & their effects cannot be anticipated.

• Central banks (esp. US Fed under Greenspan) agreed they shd not “lean against the wind” of asset price inflation. Shd target CPI, & only clear up after asset price crash.
How much rethinking since 2008?

• (1) Prominent UK academic economist, ex-MPC of BoE, Jan 2012:
  • “Keynes was a disaster. Skidelsky shd be locked up. Krugman has lost all respect in economics profession”
Rethinking? (2) Bernanke 2010

- Bernanke admitted macro models failed.
- “Do these failures of standard macroeconomic models mean that they are irrelevant or at least significantly flawed? I think the answer is a qualified no....The standard models were designed for non-crisis periods, and they have proven quite useful in that context.”
- Implication: we need different models for good times and hard times. This ignores Minsky’s basic point!

Rethinking? (3) John Taylor 2010

• “The recent crisis gives no reason to abandon the core empirical ‘rational expectations/sticky price model’ developed over the past 30 years – whether you call this type of model ‘dynamic stochastic general equilibrium’, ‘new Keynesian’, or ‘new neoclassical.” (Taylor 2010)

Rethinking? (4) Geoffrey Hodgson 2009

- “I tried **without success** to find the work of Keynes or Minsky on any reading list available on the web of any macroeconomics or compulsory economic theory course in any of the top universities in the world. Instead, there is ample evidence of student proficiency requirements in mathematics”

Rethinking? (5) David Colander 2011

• “The core macroeconomic courses teach DSGE [Dynamic Stochastic General Equilibrium] modelling almost exclusively.... The writings of Thornton, Bagehot, ..., Keynes, Minsky, Hicks, Clower, Leijonhufvud, Gurley, Davidson, Goodhardt, Clower, ... even Friedman ...are missing....”
He wrote in 2009: the standard macro models “were, by construction, ‘fair weather models’ only. When rough weather, in the form of financial turmoil, blew in, in August 2008, I expected one consolation to be growing appreciation among mainstream economists of the shortcomings of their models”.

As of 2012 he sees little change in mainstream macro
Rethinking? (7) 8 of world’s top young economists

- Ali Wyne interviewed “8 of the world’s top young economists” (< 40 y o) abt big unanswered Qs in economics, & where breakthroughs will come in next decade.
  - Wyne, Ali, 2012, “Empirics & psychology: eight of the world’s top young economists discuss where their field is going”, Big Think, July 25.
  - Only 1 said anything close to “rethink macroeconomics”
  - Others said: how to model “realistic” (not “rational”) behavior; how to reduce poverty; impact of ICTs; analysis of “Big Data”
Why neoliberal ecs *still* dominant? 

**Teaching (1)**

- **Teaching** of economics: Privileges mathematical modelling & econometric techniques over substance.
- US grad students (1987): “how important is having **thorough knowledge of the economy**?”
  - “Very important ” 3%
  - “Unimportant”  68%
  - “Being **smart in sense of problem-solving**”: “very important” 65%
Teaching of econ (2): strong socialization into norms of selfishness

• Students learn that selfishness, free riding, opportunistic behavior will be transformed by self-correcting market into socially efficient outcomes.

• Studies of free riding behavior:

• Studies of lying:
Determinants of lying when no risk of being caught

- Experiment on determinants of lying, set up to eliminate altruism or fear of getting caught
- Sender & receiver. Sender does not know, cannot see Receiver. Sender sits alone at screen that shows blue (B) or green (G) circle. Sender communicates color to Receiver.
- Sender – profit-max incentive to lie when sees B.
- Frequency of lying by sender when sees B: no diffic in rate of lying by gender, socio-ec characteristics.
- Big diffic by student’s major subject: humanities – less than 50%; other (sc, engineering) – 60%; econ – 77%

Economists: self selection or socialization?

• Do economists self-select or are they socialized through teaching?

• Study of homogeneous pool of students in Riga going into (a) Stockholm School of Econ, (b) two Latvian universities, followed over 2 years.

• Conclusion: when self-selection controlled for, strong socialization effect of mainstream economics teaching.
Why neoliberal ecs dominant? (3)

• Positive feedback loops: **promotion & journals**
• 1 American Economic Review
• 2 Econometrica
• 3 J. Political Economy
• 4 J. Economic Theory
• 5 Quarterly J. Economics

• 18 Economic Journal
Heterodox journals low ranked

• 77  *Cambridge Journal of Economics*
• 108  *Journal of Economic Issues*
• 113  *Journal of Post Keynesian Economics*

• Strong cumulative causation: the unification of economics around epistemology of mathematical formalization feeds upon itself
Why neoliberal ecs dominant? (4)

• Corporate patronage:
  Corporate patronage helps explain why few mainstream economists noticed impending crisis & urged stronger financial regulation.

• See film “Inside Job” (eg Fredric Mishkin in Iceland)

• (Economists define “corruption” too narrowly as only a public sector phenomena. Cf. pharmaceutical research: scientists who get research funds fr big pharma find results favorable to big pharma.)
Ecsts’ conflicts of interest

- Jessica Carrick-Hagenbarth and Gerald Epstein find that academic ecsts generally do not disclose possible conflicts of interest.
- Of 19 academic financial ecsts, 15 regularly worked for priv fin companies; 13 did not disclose.
Good news (1): AEA 2012

• AEA Exec Cttee Apr 2012 adopted rules of disclosure of conflicts of interest.
• But very weak: when economist receives more than $10,000 from an organization in 3 year period, must simply list the name of the organization (not amount of $) in papers in AEA journals.
• As of October 2012 no papers in AEA journals had complied, b/c rules in force only since July 2012.
• German Econ Assoc & 2 French assoc recently adopted (weak) codes of ethics
Good news (2): market fundamentalism less dominant

- For example, IMF as of past 2 years no longer reliable supporter of western economic orthodoxy
- Brazil & Singapore, & IMF Research Department, are leading the rethink inside IMF:
  - (1) IMF criticised US Fed for irresponsible QE
  - (2) IMF has moderated hostility to K controls ("counter-cyclical capital acct management")
  - (3) IMF has urged fiscal expansion

Mkt fundamentalism less dominant

- A new model of managed capitalism – nationally, globally – may be emerging out of the model of mkt fundamentalism
- Continued deployment of ICTs + reinvented economic management + rise of Asia might give cause for *optimism* abt global economic prospects over next several decades.
- But, global warming??
Future of economics?

• Question: will economists become more Humble: more epistemically equal, more epistemically cautious?
• Economics profession needs to reduce epistemic monopoly of mathematical formalism, give higher value to ‘complementary pluralism’ of approaches
• More emphasis to:
  • economic history; history of economic thought; philosophy of economics; economics & ideology; ethics
• Brazil economics profession is model for the world. Shows how to sustain a diversified economics ‘ecology’.

• David Colander, ‘The humble economist’
Innovation in exchange rate determination

- Stability of ERs imp't for all X-border activity.
- All efforts to stabilize IMS have failed in end: GS from late 19C to WW1; BW fr 45 to 71.
- Since end BW, no major innovation in ER setting for 40+ yrs
- Govts leave citizens to volatility of ER mkts, or try regional currency arrgts
- Powerful c’ies abt to inflc value of their currency thru policy; not powerless. Powerful c’ies act for national interest: “$ is our currency, yr problem”.
- Risk asymmetrical; party in whose currency transaction denominated (mostly US$) bears less risk
Innovation in ER setting (ctd)

• Danish entrepreneur Jesper Toft est’ed Global Currency Union in 08 to dev way to reduce ER volatility.

• Instead of direct exchange of currency, business contracts denominated in Global Currency Units, which vary with the currencies. The GCU for each transaction weights the 2 central currencies + other related currencies, all at current market values.

• Eg $-DKK ER: deviation b/w July 10 & Mar 12 = 18%

• Deviation of GCU = $ (25%); DKK (25); SEK (15); NOK (15); EUR (10); GBP (5); CZK (3); PLN (2) = 4%