

The crisis in macroeconomics after the financial crisis

Wyplosz (2009) observes that economists have “a pathological tendency to disagree about just everything and to do so in public.” A typical example is that leading Chicago economist Robert Barro (2009) states in his article “Voodoo Multipliers” that the Obama-team assumes that the multiplier of government spending exceeds unity. This implies that GDP rises by more than the increase in government expenditures. Barro argues that apparently “the government spending is a good idea even if the bridge goes nowhere or if government employees are uselessly filling holes. This deal would make Charles Ponzi proud.” Using calculations from World War II Barro then argues that the multiplier is well below unity.

In his blogs of 22-23 January Nobel price laureate Paul Krugman comments on Barro that during WWII consumer goods were rationed and there was full employment. He concludes: “I can’t quite imagine the mindset that leads someone to forget all this and think that you can use World War II to estimate the multiplier that might prevail in an underemployed, rationing-free economy.”

These exchanges have triggered Clive Crook to name his Financial Times column of 9 February 2009 “Politics is reducing economics to a truly dismal science”. Crook states that “Economists are failing to express anything resembling consensus on the most basic questions of economic policy.” However, “This impression of disarray – that economists have nothing clear to say on these questions – is not the fault of economics as such. It is a mostly false impression created by some of its leading public intellectuals, Mr Krugman amongst them.” (The latter because Clive Crook is shocked that Krugman has stated that raising trade tariffs can make the world better off.)

I think that Crook his picture of economics as such is far too rosy. Leading macroeconomists, like Acemoglu (2009), Buiters (2009), Eichengreen (2009), de Grauwe (2009), Krugman (2009), Spaventa (2009), Stiglitz (2009) and Wyplosz (2009), indicate that serious soul searching amongst macroeconomists is taking place. An example is Stiglitz’s (2009) (another Nobel laureate) conclusion that once the Great depression faded into memory “Dogmas and doctrines holding that markets worked well and that they were self-correcting once again came to predominate. This time, the theories were more sophisticated, but the underlying assumptions were equally irrelevant. These ideas helped shaped the intellectual milieu which gave rise to the flawed policies that, in turn, gave rise to the crisis, and to some extent, they are shaping policies today as we attempt to respond to the crisis.” This was while “other strands of modern economic theory, including the theory of imperfect information ..., were simultaneously explaining why markets often do not work so well.” And he concludes “One would have thought that this powerful combination of theory and evidence might have dampened the enthusiasm for unfettered and under-regulated markets. But evidently it did not. I understand the unbridled

enthusiasm of special interests who found the arguments for deregulation profit enhancing; I am not so clear what motivated so many economists.” He does not pursue this latter point. Krugman (2009), however, makes an interesting remark when he states that “the economics profession went astray because economists, as a group, mistook beauty, clad in impressive-looking mathematics, for truth. . . . , the central cause of the profession’s failure was the desire for an all-encompassing, intellectually elegant approach that also gave economists a chance to show off their mathematical prowess.” In line with Stiglitz’s observations, Krugman continues “Unfortunately, this romanticized and sanitized vision of the economy led most economists to ignore all the things that can go wrong. They turned a blind eye to the limitations of human rationality that often lead to bubbles and busts; to the problems of institutions that run amok; to the imperfections of markets — especially financial markets — that can cause the economy’s operating system to undergo sudden, unpredictable crashes; and to the dangers created when regulators don’t believe in regulation.”

The latter notion is elaborated elegantly by Eichengreen (2009): “What got us into this mess, in other words, were not the limits of scholarly imagination. It was not the failure or inability of economists to model conflicts of interest, incentives to take excessive risk and information problems that can give rise to bubbles, panics and crises. It was not that economists failed to recognize the role of social and psychological factors in decision making or that they lacked the tools needed to draw out the implications. In fact, these observations and others had been imaginatively elaborated by contributors to the literatures on agency theory, information economics and behavioral finance. Rather, the problem was a partial and blinkered reading of that literature. The consumers of economic theory, not surprisingly, tended to pick and choose those elements of that rich literature that best supported their self-serving actions. Equally reprehensibly, the producers of that theory, benefiting in ways both pecuniary and psychic, showed disturbingly little tendency to object. It is in this light that we must understand how it was that the vast majority of the economics profession remained so blissfully silent and indeed unaware of the risk of financial disaster.”

The question then is how to proceed. Acemoglu (2009) provides a very interesting analysis where he emphasizes that we have learned from the crisis that (1) “aggregate volatility is part and parcel from the market system” which should be analysed further – this point is also made by Buiters (2009), de Grauwe (2009), Eichengreen (2009) and Krugman (2009); (2) market regulation should recognise the opportunistic behaviour of market participants and pay more attention to the institutional environment under which markets operate – see also Eichengreen (2009), Stiglitz (2009) and Wyplosz (2009); (3) we cannot trust the long-lived large firms to

monitor themselves, which implies that we have to give more weight to the reputations of firms in thinking about regulations and institutions and we have to analyse the internal working of firms better.

Spaventa (2009) and Wyplosz (2009) make a similar observation, but then in relation to the political sector: As Wyplosz states: “It is all well to give fine advice, but we also need to understand whether the policy makers can do what we ask them to do.” And Spaventa (2009) warns us: “As in churches, the message to the congregation must be clear and unequivocal, even if clerics are not bound by the simplistic orthodoxy of an elementary catechism and are allowed to express doubts and draw distinctions among themselves. Though economists would not provide simple truths in their research work, some were ready to distil them for popular use in OpEds and blogs, and few in any case objected to the vulgate version which became popular with the congregation. They should have been suspicious, because theirs was a peculiar congregation, consisting not only of policymakers, central bankers and sundry regulators, but even more of private sector agents in search of arguments justifying financial deregulation for their own private interest.”

Three elements which are very important in my view, but receive only little attention in the articles cited below are economic growth, global imbalances and post-Keynesian theories. Not surprisingly, Acemoglu (2009) is the only one who emphasises that economic growth is an important element which has not been included in the discussion of economic crisis. “Economic growth ought to be a central part of the discussion, not an afterthought.” The reason is obvious: sustainable growth is the ultimate source of our welfare. Second, in particular Krugman and Buter have stressed many times in their blogs that global imbalances are an important element in the analysis of the financial crisis. It is obvious including global imbalances complicates the macroeconomic analysis considerably – but at some stage this cannot be avoided. Last but not least I think more attention should be paid to post-Keynesian thinking, how hopelessly divided the authors of this group might be amongst themselves. The emphasis of Minsky and Skidelsky on uncertainty as opposed to risk, and the eclecticism with respect to the use of macroeconomic models that follows from it, is refreshing in these days. Similarly the radical proposals discussed in The Levy Economics Institute of Bard College can stimulate us to adopt new ideas.

With respect to the latter, Galbraith (2009) reports on a recent conference where such ideas were discussed. The proposals follow from the recognition that economic activities with strong external effects for the public sphere should be under direct government control. For instance, there is no reason why “the ‘critical system infrastructure’ [of the financial sector] presently administered by large banks, ... should not be managed in the public sector, as a public utility.” There is “no alternative to the permanent restoration of national or equivalent public power (in the case of the EU, European power) over all financial institutions. Banks are public-private partnerships, funded partly at public risk (via deposit insurance and implicit guarantees). They cannot logically operate independently of the power that guarantees their funding, and the attempt to allow them to do so is intrinsically destabilizing.” Next to that one should recognize that “efforts to revive the economy by first reviving the financial sector cannot work. The correct approach to increase the level of economic activity and employment should instead consist of measures run through the public sector, the household sector, and the business sector.” In that context one should also see the proposal on the Job Guarantee as elaborated in Mitchell and Muysken (2008) to guarantee full employment without inflationary pressures.

I think it is obvious that the macroeconomic discipline is in a disarray, and some serious changes will occur. The New-Keynesian approach has manifestly failed. One might be tempted to follow Buiter’s (2009) half-hearted advice to “shed the conventional wisdom of the typical macroeconomics training of the past few decades. In its place is an intellectual potpourri of factoids, partial theories, empirical regularities without firm theoretical foundations, hunches, intuitions and half-developed insights. It is not much, but knowing that you know nothing is the beginning of wisdom.” This would also be in line with Krugman’s (2009) conclusion. Whatever the case, I agree with Stiglitz (2009) that “There is a rich research agenda ahead.” I hope we will live up to the challenge and will succeed in finding a more constructive and productive form for our public debates.

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