Beauty $\neq$ Truth? Thoughts on Krugman's 'How did economists get it so wrong?'

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It will be some years before the global economy recovers from the crisis that engulfed global financial markets in the course of 2008.² Unemployment in the eurozone and the US is close to 10 per cent, and there is little to suggest that the situation is going to improve rapidly. The effort to stave off total economic collapse has left governments burdened with massive debt that will take years of painful effort to work off.

In one respect, though, recovery seems almost complete. The economics profession, which was briefly shamefaced by the failure to predict the crisis, or to reach any general agreement on its causes and the appropriate policy response, seems to have recovered its self-esteem. Quite a few economists seem ready to dismiss the entire crisis as a 'transitory volatility blip' (Coibion and Gorodnichenko 2010).

The policy prescriptions of market liberalism, including deregulation, privatisation and regressive tax 'reform', are being advanced with seemingly undiminished confidence. On the most charitable view possible, the adoption of these policy prescriptions did nothing to protect national economies from the worst impacts of the crisis. In fact, several of the hardest-hit, including Iceland, Ireland and the Baltic States were previously the subject of glowing praise for their embrace of market liberalism.

Among the exceptions to this complacent attitude, Paul Krugman has been notable for his willingness to consider the failures in economic analysis exposed by the crisis. Unsurprisingly, much of his attention has focused on the response of economists associated with the 'freshwater' or 'Chicago school' of macroeconomics.

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² This comment draws on my forthcoming book, *Zombie Economics: How Dead Ideas Still Walk Among Us* (Princeton University Press 2010).

However, Krugman has also pointed out the inadequacies the ‘saltwater’ or ‘New Keynesian’ group with which he is commonly associated. As he notes, this group embraced the spurious claim that the US and world economies were enjoying a ‘Great Moderation’ in which the business cycle had been tamed. They differed from their freshwater rivals only in the extent to which they regarded this happy outcome as the result of the stabilisation policies of central banks.

Both groups, Krugman says, mistook beauty, clad in impressive-looking mathematics, for truth.

Krugman cites Olivier Blanchard’s bald statement that ‘the state of macro is good’. Rather more insight can be obtained from the following, literally poetic, and somewhat ironic, metaphor:

A macroeconomic article today often follows strict, haiku-like, rules: It starts from a general equilibrium structure, in which individuals maximize the expected present value of utility, firms maximize their value, and markets clear. Then, it introduces a twist, be it an imperfection or the closing of a particular set of markets, and works out the general equilibrium implications. It then performs a numerical simulation, based on calibration, showing that the model performs well. It ends with a welfare assessment.

The class of models to which Blanchard refers encompasses the intellectual successors of both the Real Business Cycle models of the 1980s and the New Keynesian challenges to these models. They may be described as dynamic stochastic general equilibrium (DSGE) models.

As Blanchard observes:

Such articles can be great, and the best ones indeed are. But, more often than not, they suffer from some of the flaws I just discussed in the context of DSGEs: Introduction of an additional ingredient in a benchmark model already loaded with questionable assumptions. And little or no independent validation for the added ingredient.

Blanchard’s description brings out the central role of microeconomic foundations in the DSGE framework, and illustrates both the strengths and the weaknesses of the approach. On the one hand, DSGE models were able to represent a wide range of economic phenomena, such as unemployment and asset price bubbles, while remaining within the classical general equilibrium framework. On the other hand, precisely because the analysis remained within the general

equilibrium framework, it did not allow for the possibility of a breakdown of classical equilibrium, which was precisely the possibility Keynes had sought to capture in his general theory.

The requirement to stay within a step or two of the standard general-equilibrium solution yielded obvious benefits in terms of tractability. Since the properties of general-equilibrium solutions have been analysed in detail for decades, modelling 'general equilibrium with a twist' is a problem of exactly the right degree of difficulty for academic economists — hard enough to require, and exhibit, the skills valued by the profession, but not so hard as to make the problem insoluble, or soluble only with the abandonment of the underlying framework of individual maximisation.

The DSGE approach has failed to generate a truly progressive scientific-research programme. A study of some new problem such as the incentive effects of executive pay would typically begin with the standard general-equilibrium model, disregarding the modifications made to that model in previous work examining other ways in which the real economy deviated from the modelled ideal.

By contrast, a scientifically progressive programme would require a cumulative approach, in which empirically valid adjustments to the optimal general-equilibrium framework were incorporated into the standard model taken as the starting point for research. Such an approach would imply the development of a model that moved steadily further and further away from the standard general-equilibrium framework, and therefore became less and less amenable to the standard techniques of analysis associated with that model.

As Krugman says, DSGE modelling was beautiful (at least to economists) and illuminated some aspects of the truth, but beauty came first. An approach based on putting truth first would have incorporated multiple deviations from the standard general-equilibrium model and then attempted to work out how they fitted together. In many cases, the only way of doing this would probably be to incorporate ad hoc descriptions of aggregate relationships that fitted observed outcomes, even if it could not be related directly to individual optimisation.

These criticisms apply in particular to New Keynesian macroeconomics. New Keynesianism was ideally suited to the theoretical, ideological and policy needs of the Great Moderation. On the one hand, and unlike New Classical theory, it justified a significant role for monetary policy, a conclusion in line with the actual policy practice of the period. On the other hand, as Krugman observes, by remaining within the general-equilibrium framework the New Keynesian

school implicitly supported the central empirical inference drawn from the observed decline in volatility; namely, that major macroeconomic fluctuations were a thing of the past.

The failure of DGSE models to predict the crisis or to provide useful policy guidance requires a return to the basic Keynesian insight that the economy can be far away from general equilibrium for long periods. This does not mean abandoning all the work of the past 30 years and returning to old-style Keynesianism. But it does mean starting from the traditional Keynesian perspective that a general macroeconomic theory must encompass the reality of booms and slumps and, particularly, of sustained periods of high unemployment that cannot be treated as marginal and temporary deviations from general equilibrium. We must model a world where people display multiple and substantial violations of the rationality assumptions of microeconomic theory and where markets depend not only on prices, preferences and profits but on complicated and poorly understood phenomena like trust and perceived fairness.

First, the programme needs more realistic micro-foundations. As Akerlof and Shiller (2009) observe, we need to look at how people actually behave, and how this behaviour contributes to the performance of the economy as a whole.

Second, we need to reconsider the concept of equilibrium. The whole point of Keynes' General Theory was that the market-clearing equilibrium analysed by the classical economists, and central to DSGE models, was not the only possible equilibrium. An economy can settle for long periods in a low-output, high-unemployment state that may not meet the neoclassical definition of equilibrium, but does match the original concept, borrowed from physics, of a state in which the system tends to remain and to which it tends to return. More importantly, perhaps, we need a theory which encompasses crises, and rapid jumps between one kind of equilibrium and another. Ideally, this will combine 'old Keynesian' analysis of economic imbalances with a Minsky-style focus on financial instability.

Between these two levels, we need to consider the fact that the economy is not a simple machine for aggregating consumer preferences, and allocating resources accordingly. The economy is embedded in a complex social structure, and there is a continuous interaction between the economic system and society as a whole. Phenomena like 'trust' and 'confidence' are primarily social, but they affect, and are affected by, the performance of the economic system.

An approach to economics that has been dominant for more than three decades will not go away simply because its predictions are inconsistent with the facts.

It is necessary to provide an alternative. The key requirements can be summed up by three simple propositions. In the twenty-first century, economics should focus:

- More on realism, less on rigor
- More on equity, less on efficiency
- More on humility, less on hubris.

The prevailing emphasis on logical rigor has given economics an internal consistency that is missing in other social sciences. But there is little value in being consistently wrong. Economics must move on from the infinitely rational, farsighted and asocial beings whose decisions have been the central topic of analysis in recent decades.

Three decades in which market liberals have pushed policies based on ideas of efficiency and claims about the efficiency of financial markets have not produced much in the way of improved economic performance, but they have led to drastic increases in inequality, particularly in the English-speaking world. Economists need to return their attention to policies that will generate a more equitable distribution of income.

Finally, with the collapse of yet another economic 'New Era' it is time for the economics profession to display some humility. More than two centuries after Adam Smith, economists have to admit the force of Socrates' observation that 'The wisest man is he who knows that he knows nothing'. While knowledge in the sense of absolute certainty may be unattainable, economists can still contribute to a better understanding of the strengths and weaknesses of markets, firms and other forms of economic organisation, and the possibilities for policy action to yield improved economic and social outcomes.

Every crisis is an opportunity. The global financial crisis gives the economics profession the chance to rethink ideas that led the world into crisis, and to produce more realistic, humble and, above all, socially useful bodies of thought.

References

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