

Economics failed us before the global crisis

Analysis of macroeconomic theory suggests substantial ignorance of how economies work

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Martin Wolf MARCH 20, 2018

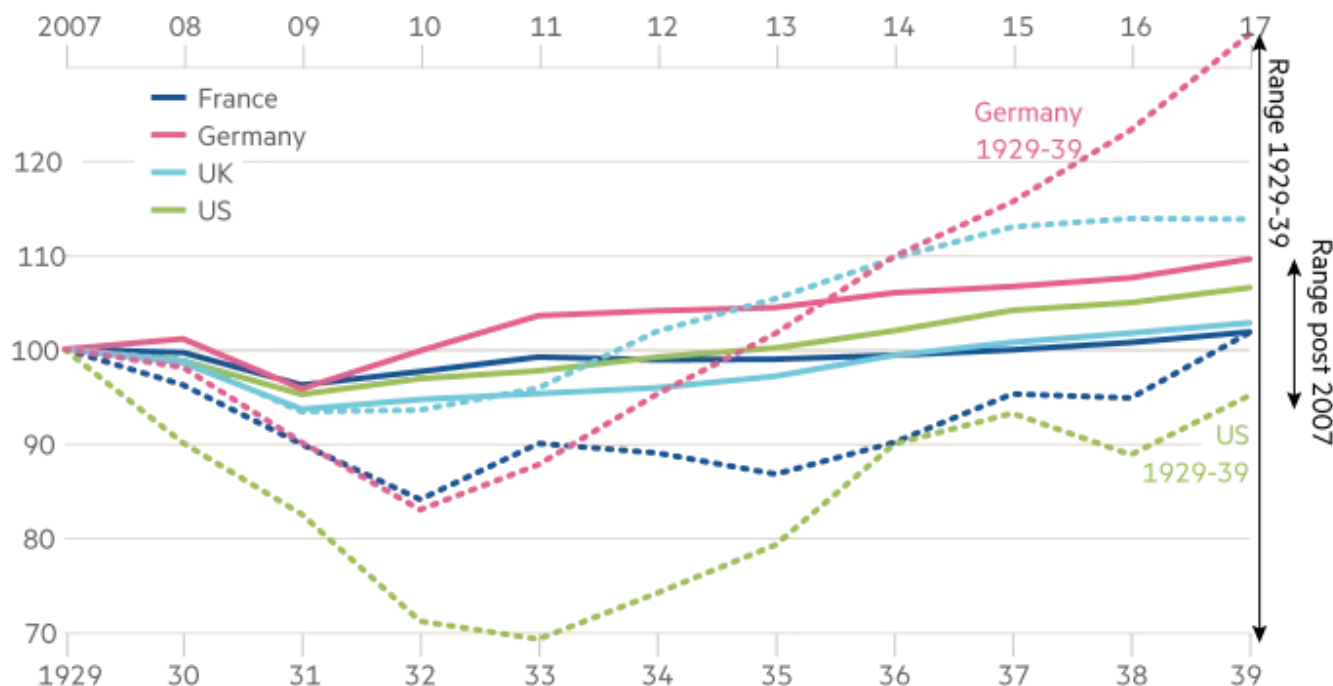
Economics is, like medicine (and unlike, say, cosmology), a practical discipline. Its goal is to make the world a better place. This is particularly true of [macroeconomics](#), which was invented by John Maynard Keynes in response to the Great Depression. The tests of this discipline are whether its adepts understand what might go wrong in the economy and how to put it right. When the financial crisis that hit in 2007 caught the profession almost completely [unawares](#), it failed the first of these tests. It did better on the second. Nevertheless, it needs rebuilding.

In a blog for the Financial Times in 2009, Willem Buiter, now at Citi, [argued](#) that: “Most mainstream macroeconomic theoretical innovations since the 1970s . . . have turned out to be self-referential, inward-looking distractions at best.” An exceptionally thorough [analysis](#), published in the *Oxford Review of Economic Policy*, under the title “Rebuilding Macroeconomic Theory”, leads this reader to much the same position. The canonical approach did indeed prove gravely defective. Moreover, top class professional economists differ profoundly on what to do about it. Socrates might say that awareness of one’s ignorance is far better than the illusion of knowledge. If so, macroeconomics is in good shape.

Less volatile this time

Real GDP per head at purchasing power parity, rebased (1929 = 100, 2007 = 100)

Dotted lines indicate 1929-1939 data



Sources: Angus Maddison; IMF

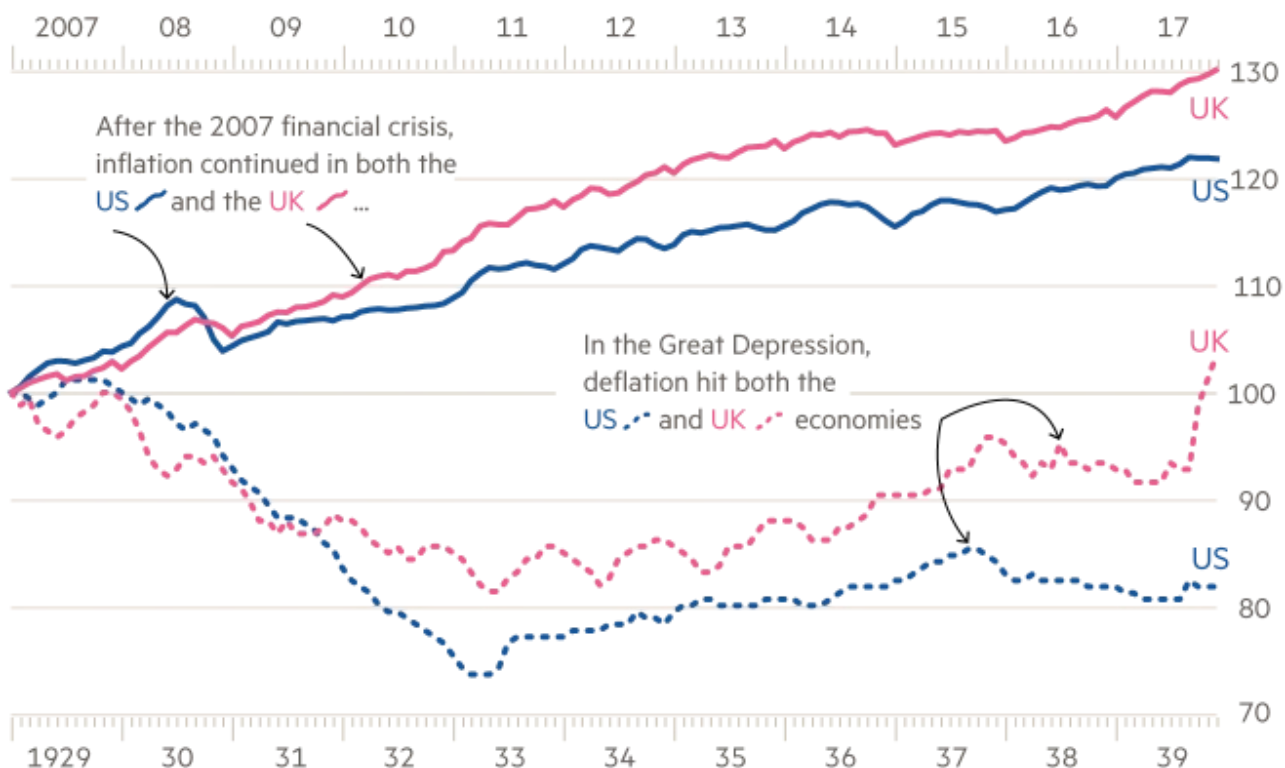
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As David Vines and Samuel Wills explain in their excellent overview, the core macroeconomic model rested on two critical assumptions: the efficient markets hypothesis and rational expectations. Neither looks convincing today. It is questionable whether it is even possible to have “rational expectations” of a profoundly uncertain future. Such uncertainty helps explain the existence of institutions — money, debt and banks — whose effects are so significant and yet were largely ignored in standard models. It is better to be roughly right than precisely wrong. Thus, Hyman Minsky’s view of the [dangers of speculative tendencies](#) in finance was roughly right, while many of the brightest macroeconomists proved precisely wrong.

It is not good enough to argue that the canonical model works in normal times. We need also to understand the risks of crises and what to do about them. This is partly because crises are, as the Nobel-laureate Joseph Stiglitz notes, the most costly events. A macroeconomics that does not include the possibility of crises misses the essential, just as would a medicine that assumes away the possibility of heart attacks. Moreover, crises are endogenous: that is to say, they come from within the economy. They are a result of the interaction between tendencies towards excessive optimism and the fragility of any system of highly leveraged financial intermediaries.

Deflation avoided

Consumer price indices, rebased*, (Jan 1929 = 100, Jan 2007 = 100)



*1929-39 data for the UK is the Cost of Living Index

Source: Bureau of Labor Statistics, Bank of England

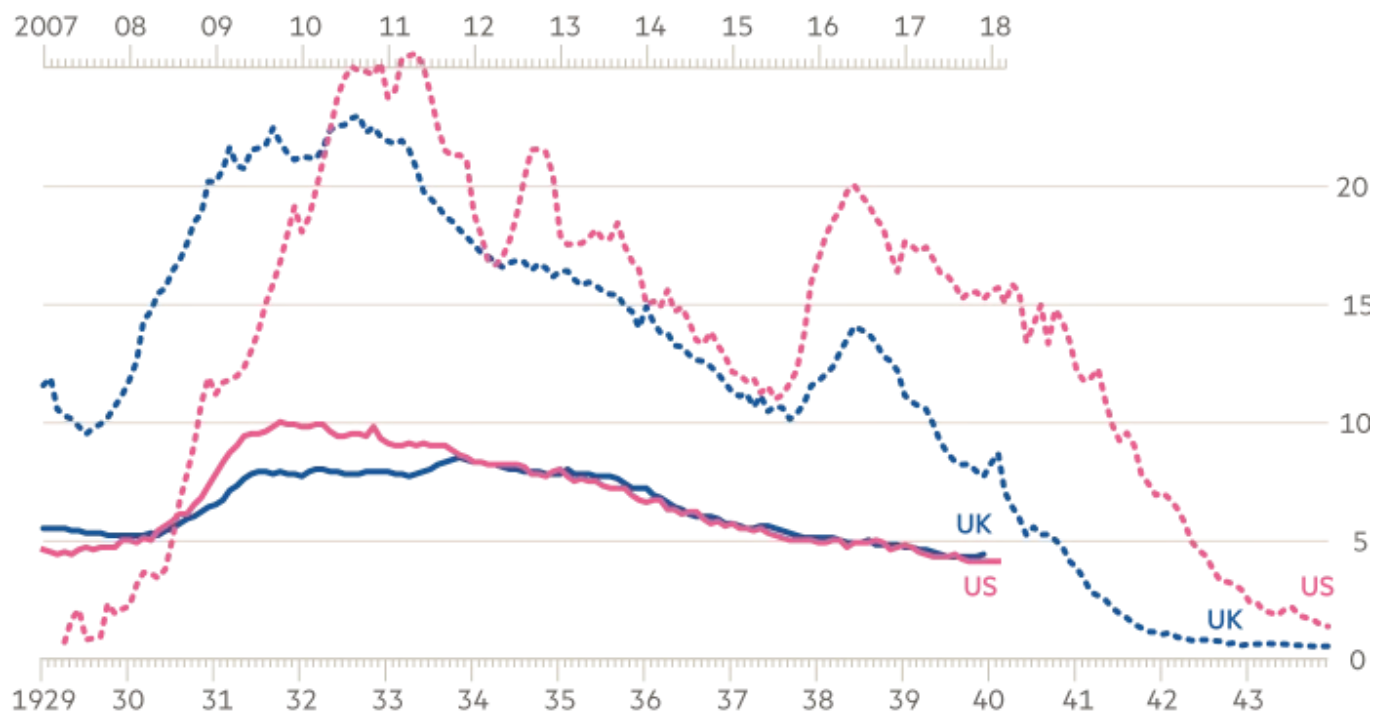
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My colleague [Martin Sandbu notes](#), in particular, the possibility of “multiple equilibria” — the idea that economies might end up in self-reinforcing bad states of the world. This possibility makes it vital to respond to crises forcefully. Doctors’ first response to a heart attack is, after all, not to tell the patient to go on a diet. That happens only after they have dealt with the attack itself.

Lower peak unemployment this time ...

Unemployment rates (%)

Dotted lines indicate 1929-1939 data



Bureau of Labor Statistics, Bank of England, Thomson Reuters Datastream
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So a big question is not only whether we know how to respond to a crisis, but whether we did so. In his contribution, the Nobel laureate Paul Krugman argues, to my mind persuasively, that the basic Keynesian remedies — a strong fiscal and monetary response — remain right. Also vital is swift revitalisation of the banking system. The contrast between the swifter US recovery and the dreadful delays in the eurozone gives striking support for this view. Essentially, the latter lost five years before the recovery began.

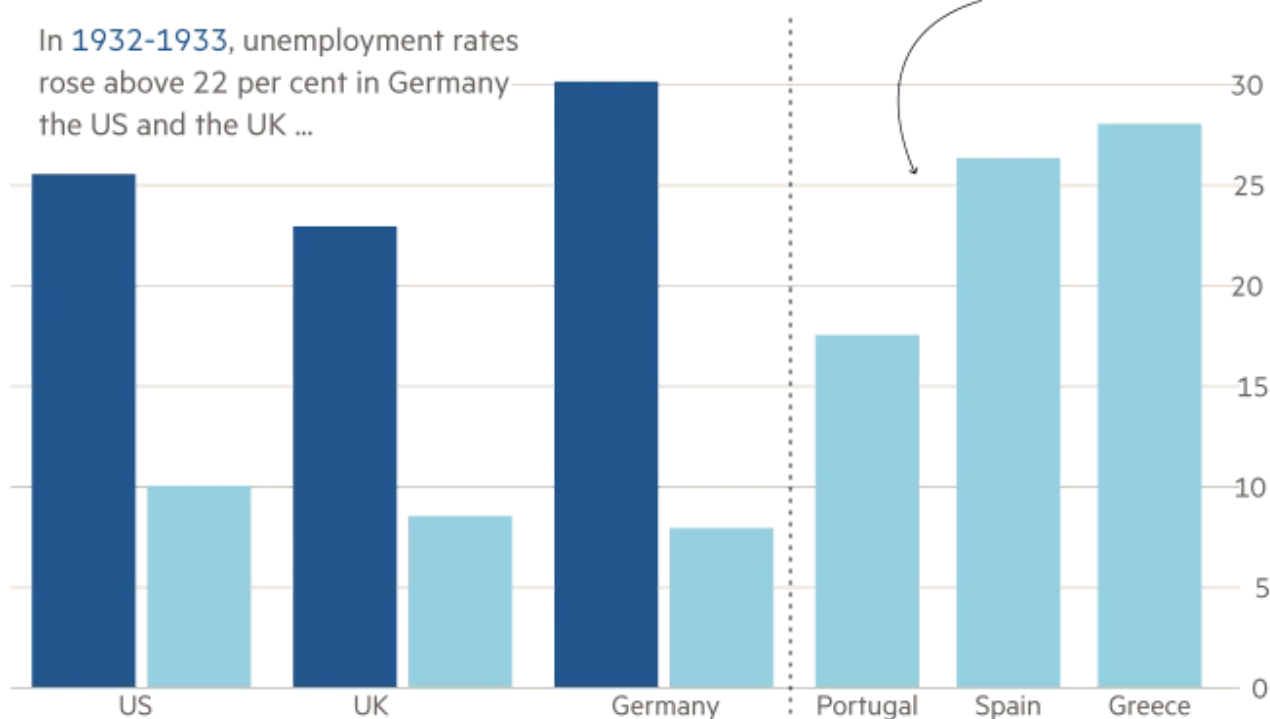
... but not for the eurozone periphery

Peak unemployment rates (%)

■ 1932-33 ■ Post 2008

In 1932-1933, unemployment rates rose above 22 per cent in Germany the US and the UK ...

... while during the post 2008 crisis such rates were only seen in the EU periphery



Sources: Bureau of Labor Statistics; Bank of England; Thomson Reuters Datastream

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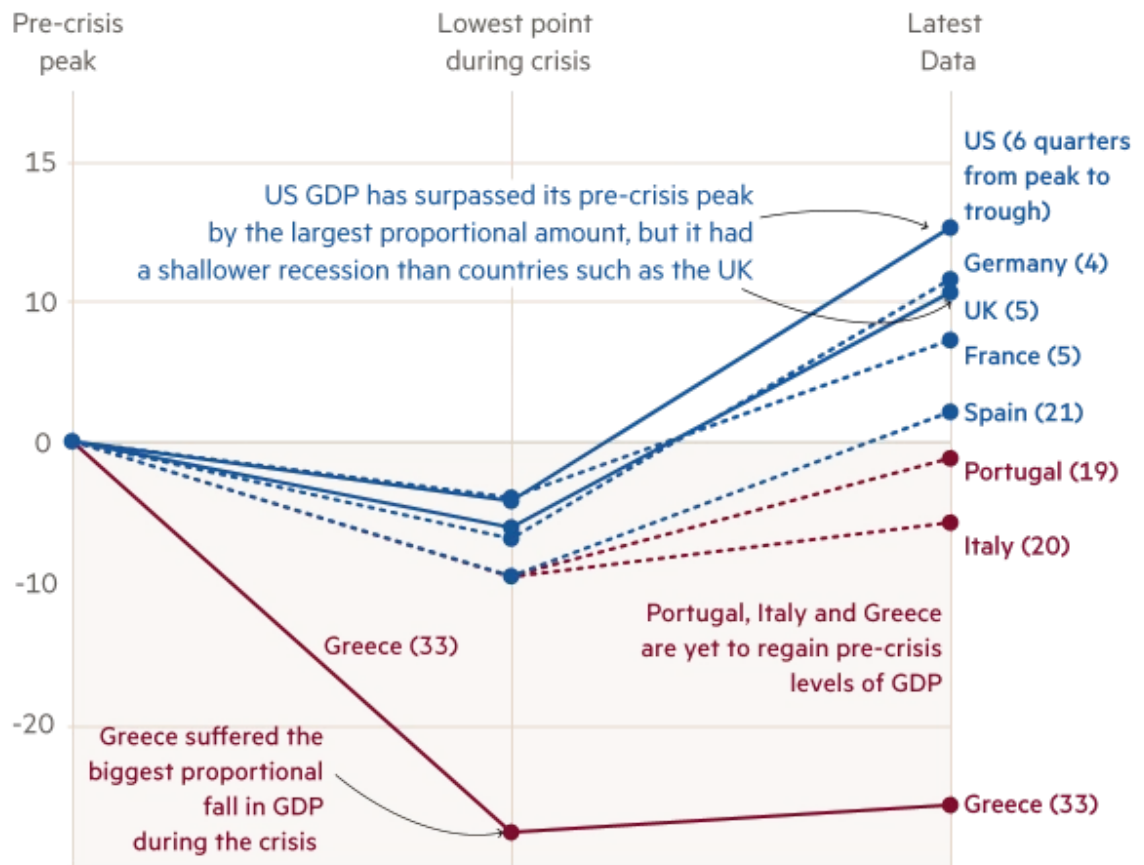
A comparison between what happened in the 1930s and this post-crash period shows we have indeed learnt some important things. Compared with the Great Depression, the immediate declines in output and rises in unemployment were far smaller. Moreover, prices have also been far more stable this time. These are true successes. Nevertheless, after a decade, the level of output per head, relative to pre-crisis levels, is less impressive: Germany and the UK did even better last time. Moreover, the worst hit eurozone countries have suffered badly, by any standards. This recovery really has not been a triumph.

This suggests that fixing a huge crisis after the event is terribly hard. The obvious need then is to make economies more resilient. Even if we do not fully understand the economic dynamics, the broad lessons for the reform of our economies seem clear. Economies would be more resilient if they were less highly leveraged and, in particular, if they depended less on holdings of money backed by risky assets owned by the highly leveraged financial intermediaries known as banks. Obvious solutions include eliminating the incentives towards leverage in our tax systems, encouraging greater use by the economy of equity finance and debt that can be readily converted

into equity, raising the reserve and capital requirements of banks and moving swiftly towards the issuance of digital central bank cash.

... which suffered huge recessions

Cumulative % change in GDP from peak output in 2007/08



Source: Thomson Reuters Datastream
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The analysis of fundamental macroeconomic theory suggests substantial ignorance of how our economies work. This is not that surprising. We may never understand how such complex systems — animated, as they are, by human desires and misunderstandings — actually function. This does not mean that attempting to improve understanding is a foolish exercise. On the contrary, it is important. But it is arguably more vital in practice to focus on two other tasks. The first is how to make the body economic more resistant to the consequences of manias and panics. The second is how to restore it to health as quickly as possible. On both counts, we need to think more and do more. These are the practical challenges before us.

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Letters in response to this column:

Macroeconomics and the unknowable future / From Alex J Pollock, Washington, DC, US

Business cycles must run their course / From David Parker, San Francisco, CA, US

Spending on war machine revived German economy after the Great Depression / From Guy Wroble, Denver, CO, US

Don't blame science if politicians won't learn / From Lajos Bokros, Budapest, Hungary

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