Time to bury the zombie economics that led us into the crisis and produce more realistic, socially useful ideas.

Nov 24 2010

The effects of the global financial crisis make the headlines everyday in the UK and most of the developed world. Yet at the core of the financial and intellectual institutions that created the crisis, the meltdown of 2008 is already a distant memory. **Professor John Quiggin** *examines the 'zombie' economic ideas that led us into the crisis and argues that we need to abandon theories based on absolute individual rationality and better understand the 'animal spirits' that can lead to boom and bust. He will give a public lecture on 25 November at the LSE at 6:30pm. For more details please click here.*

For most people in the UK, Europe, and the US, the consequences of the Global Financial Crisis are impossible to ignore. While unemployment has fallen slightly in the UK to around 8 per cent, it still hovers at around 10 per cent in rest of the EU and the US, and economic growth is sluggish at best. And of course, matters are far worse in the European periphery, where the losses of the financial system exceed the capacity of governments to rescue them. The collapse of the Irish government yesterday will certainly not be the last.

Yet on Wall Street banks are making huge profits, and paying out huge bonuses. And, within the economics profession, ideas that seemed dead and buried as a result of the crisis are clawing their way up through the soft earth. Tomorrow I will present the findings of my book, *Zombie Economics: How Dead Ideas Still Walk Among Us* at a public lecture at the London School of Economics, and will describe some of these ideas and how they played a role in the crisis. They include:

- The Great Moderation: the idea that the period beginning in 1985 was one of unparalleled macroeconomic stability;
- The Efficient Markets Hypothesis: the idea that the prices generated by financial markets represent the best possible estimate of the value of any investment;
- Dynamic Stochastic General Equilibrium: the idea that macroeconomic analysis should not concern itself with economic aggregates like trade balances or debt levels, but should be rigorously derived from microeconomic models of individual behaviour;
- The Trickle-Down Hypothesis; the idea that policies that benefit the well-off will ultimately help everybody; and
- Privatization; the idea that any function now undertaken by government could be done better by private firms.

Together these ideas form a package which has been given various names: 'Thatcherism' in the United Kingdom, 'Reaganism' in the United States, 'economic rationalism' in Australia, the 'Washington Consensus' in the developing world and 'neoliberalism' in academic discussions.

Among these ideas, the central and most clearly falsified are the supposed Great Moderation in economic volatility and the Efficient Financial Markets Hypothesis.

The 'Great Moderation' was the claim that the period from the mid-1980s onwards was one of permanently reduced volatility in output, employment and other economic variables. This claim bolstered the view that reliance on monetary policy alone was sufficient to achieve an optimal degree of macroeconomic stability, and that fiscal policy should be focused on budget balance.

Claims of a Great Moderation were bolstered in their turn by the Efficient Financial Markets Hypothesis which (in the strong forms relevant for public policy) stated that the prices generated by financial markets represented the best possible estimate of the value of any asset, given the available information. It follows that market bubbles are impossible and that the deregulation of financial markets should helped to stabilise the real economy. The Great Moderation was seen as empirical confirmation of the benefits of liberalised markets.

These ideas were clearly refuted both by the Global Financial Crisis and by the success of fiscal stimulus in those countries where it was adopted early and vigorously, such as Australia, Canada and China. Even in the US, it seems clear that the limited stimulus introduced by the Obama Administration prevented an even worse downturn. In any case, while the empirical issues will take a long time to resolve, the theoretical basis for opposition to fiscal stimulus has collapsed.

The question, though, is how to replace these failed ideas. This is not the first time an imposing edifice of economic thought has collapsed in the face of economic events beyond its capacity. Classical economics had no response to the Great Depression and was replaced by Keynesianism. The postwar synthesis of Keynesian macroeconomics and neoclassical microeconomics was dominant through nearly three decades of strong economic growth and full employment (known as the *Trente Glorieuses* in France, and more prosaically as the Long Boom in the English-speaking world). But Keynesianism had no response to the stagflation that emerged in the late 1960s, and it was replaced in turn by Milton Friedman's monetarism, which gradually evolved into the Dynamic Stochastic General Equilibrium (DSGE) model, that is the third of my zombie ideas.

In the wake of the stagflation of the 1970s, critics of Keynes like Chicago University economist Robert Lucas argued that macroeconomic analysis of employment and inflation could only work if it were based on the same microeconomic foundations used to analyze individual markets, and the way these markets interacted to produce a general equilibrium.

The result was a thing of intellectual beauty, compared by IMF Chief Economist Olivier Blanchard to a haiku. By adding just the right twists to the model, it was possible to represent booms and recessions, at least on the modest scale that prevailed during the Great Moderation, and to derive support for the monetary policy , based on Taylor rules, that was credited with delivering economic stability.

But when the crisis came, all this sophistication proved useless. DSGE macroeconomics was not only incapable of predicting the crisis, it provided little or no useful advice on how to respond to it. Yet, in the absence of any alternative, it continues to dominate the journals. Google scholar reveals over 1000 articles on DSGE published in 2010. Some of these are reconsiderations of the DSGE approach in the light of the crisis, and a larger number represent attempts to incorporate financial shocks. The great majority though, are 'normal science' papers, representing the pursuit of research agendas begun in the Great Moderation and pushed to fruition as if nothing had changed.

In my book, I make some proposals for a better way forward for economics. Although the crisis has indicated the continued relevance of Keynesian ideas, the New Keynesian attempt to provide Keynesianism with rigorous foundations in neoclassical microeconomics has proved to be a failure. And it is not sufficient to return to the good Old Keynesian religion of the postwar era, at least until we can better understand the reasons for its failure in the 1970s.

Rather, the way forward must involve a number of steps towards a more realistic model of macroeconomic processes. At the individual level, a good start would be to abandon the unboundedly rational representative agent found in the typical DSGE model. Instead, we need to take account of the fact that no one is perfectly rational, and that macroeconomic shocks such as recessions affect different people differently.

Instead of rational expectations, we need a model of 'animal spirits', in which people suddenly become aware of possibilities they have previously disregarded, leading to surges of optimism and pessimism. This would fit naturally into a theoretical account of the 'Minsky moment' in which the euphoria of a speculative boom turns suddenly to panic.

It is not sufficient simply to model macroeconomic events as an aggregation of individual choices. Social phenomena such as trust and confidence in institutions are crucial in understanding macroeconomic outcomes. Such phenomena may not lend themselves to the neat analytical solutions that characterize a neat DSGE model, but they cannot be ignored.

My final conclusions is that economists need to focus

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

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

This entry was posted in Austerity and Economic policy, John Quiggin and tagged bonuses, boom and bust, budgets, Euro, government, Keynesianism, macroeconomic policy, politics, UK, uk government, uk politics. Bookmark the permalink. Edit