

# **Economics After the Crash**

Karl Whelan  
University College Dublin  
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# What Did the Crash Tell Us About Economics?

- Economics provokes a lot of opinions, including from many people have not studied the subject in depth.
- The global financial crisis and Great Recession (and closer to home Ireland's banking crisis) have seen old criticisms intensified and new ones emerge.
- Some are fair, others less so, but plenty of reason to take stock of the profession.

# “Teaching Economics After the Crash”

- “Teaching Economics After the Crash” was an interesting documentary recently broadcasted on BBC radio.
- It repeated a lot of common critiques of economics:
  - Abstract and out of touch with the real world.
  - Biased towards right-wing market ideology.
  - No role for developments in the financial sector.
  - Exposed as a failure because economists didn’t predict the crisis.
- Let’s look at some quotes from students in the documentary.

# Abstract and Out of Touch?



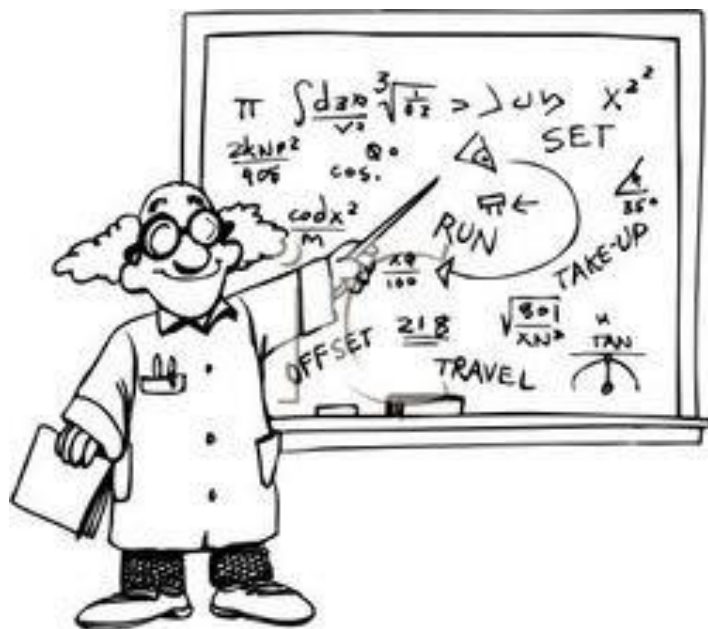
*“It felt like doing economics was being asked to go into a bubble. Sometimes our tutors actually said out loud “Don’t try to think about this in relation to current events or don’t try to think about this in relation to the news headlines right now ... Go into the library and do your problem sets.”*

# Abstract and Out of Touch?



*“Economics was in a state of uncertainty and flux and in a place where it didn’t have all the answers and then to come to uni and find people saying “this is how it works, learn it, recite it and we’ll do a multiple choice test for you at the end of the year” and one of the things I will never forget is when an economics student came up to me and said “I feel so embarrassed when my friends and family say ‘What’s going on with the financial crisis?’ and I just don’t know what to tell them. I don’t feel anything I have learned can explain to them satisfactorily what’s going on.”*

# Abstract and Out of Touch?



*"I was amazed at what the economics was that I was learning. I didn't recognise it to be what I understood as economics at all. And I assumed there would be discussion and I assumed we would be talking about the real world but it was just incredibly abstract theory and only one theory which didn't help explain anything at all."*

# Guilty or Not Guilty?

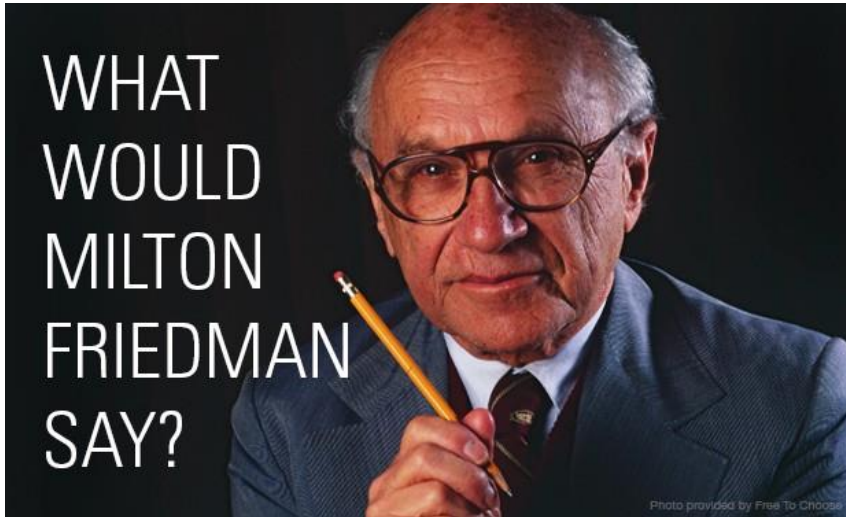
- **Not Guilty:**

- Students complain about lots of subjects and impatience with learning basics is understandable.
- Particularly true in economics because people want to relate it to their daily lives and current events.

- **Guilty:**

- Given availability of information from the Internet, universities could do a much better job at linking to the real world.
- Textbooks are out of touch with how people learn today.
- Innovations such as the CORE project a fairly small step along the way.
- Failure to explain role of theory: Need to engage with critique -- “People don’t act that way so this model is false and therefore useless”

# Economists as Neoliberals



Victoria Bateman (Cambridge): *“At the fundamental root cause of the crisis is the belief of economists in the free market capitalist system and the result of this growing faith, that really began in the 1980s with the rise of Margaret Thatcher and with Reagan in the US, the result of that belief was a liberalisation of markets, privatisation, the rolling back of the state, deregulation of the financial sector. And so we began to experience full-blown capitalism. That it would be set forth free reign and the result would be low unemployment, inflation that was under control, respectable even high economic growth rates. The result was that, on the eve of the global financial crisis, economists were looking ahead and imagining a rosy future.”*



# Is Academic Economics Really Neoliberal?

- An **enormous** amount of undergrad economics focuses on why free markets fail to produce the best outcome.
- After introduction to supply and demand, most undergrad micro focuses on why free markets produce bad outcomes.
  - Industrial organisation focuses on problems due to **imperfect competition**.
  - Public economics focuses on **externalities, public goods** and **inequality**.
  - Advanced micro theory focuses on **asymmetric information** and **co-ordination problems**.
- Mainstream macro is distinctly Keynesian in focus, emphasising sub-optimality of laissez faire approach and the need for systematic use of fiscal and monetary policy.

# Are Economists Neoliberal?

- Fourcade, Ollion and Algan (2013)
  - *“Politically, economists vote more to the left than American citizens, like most of their university-based peers.”*
  - *“economists are situated about halfway between humanities scholars and other social scientists to their left and business school professors to their right in most of their political opinions. “*

# Why Aren't Economists More Left Wing?

- Theory provides plenty of basis for left-wing positions.
- But governments are not perfectly informed benign social planners. And policies are the outcome of a complex and politicised process with incomplete information and lobbying from vested interests.
- So interventionist policies to offset the problems due to free markets comes with its own set of problems.
- Some economists focus on the problems due to government intervention more than others depending on their ideological slant.
- At its best, however, the profession takes an evidence-based approach to assessing the impact of policy interventions.

# Did Economists Ignore Banking?

- No. Lots of relevant literature part of standard graduate school literature, e.g.
  - Bernanke on the Great Depression
  - Diamond-Dybvig on runs and liquidity.
  - Stiglitz-Weiss on credit rationing
  - Shiller on volatility and irrational exuberance.
- Yes:
  - Banking crises a long time in the past in most modern economies, so little emphasis on it in undergraduate syllabus.
  - Banking regulation largely a topic for microeconomic banking experts in central banks rather than macro modellers.
  - Little attention paid by academics to important changes in financial architecture such as shadow banking, derivatives, repo markets.

# And Some Right-Wing Economists Really Did Contribute to the Crisis



*"I found a flaw in the model that I perceive is the critical functioning structure that defines how the world works, so to speak."*

*"I made a mistake in presuming that the self-interests of organisations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms."*

# Prediction as the Litmus Test

- For many, the failure of mainstream economics to predict or prevent the global economic crisis indicates that the subject has failed and needs to be fundamentally re-thought.
- Most people don't know that
  - Most economists are not macroeconomists.
  - Of those who are macroeconomists, almost none publish forecasts for a living.
  - And macro forecasting has always been hard. Those who do it well are probably lucky rather than good (D'Agostino, McQuinn and Whelan, *JMCB*, 2012).

# Macro Versus Weather Forecasting

- People joke about weather forecasting but those guys have it easy. They know the underlying laws of physics that drive the weather, which is a great place to start.
- We don't know the underlying equations that determine one person's economic behaviour.
- We couldn't even begin to imagine writing down the "right model" for data generated by the behaviour of the 7 billion people interacting with each other.
- Looked at this way, expectations for macroeconomic forecasting should be set very low.

# So What's the Point in Macro?

- Macro can explain
  - Important facts (such as how spending equals income in a closed economy)
  - Important patterns in historical data.
  - Good for “What if?” analysis i.e. if X happened, then what usually happens to Y? Not always useful for forecasting (it may not be easy to forecast whether X is going to happen) but can be useful for policy formulation.
- This might all sound a bit limited but it has its uses.
- For example, U.S. macroeconomic policy making in 2008/09 was certainly much better than it was during the Great Depression partly because the Fed and President had better ideas about macro than their 1930s counterparts.



# Why Not More “Schools of Thought”?

- The “revolting students” demand “pluralism”, i.e. exposure to different “schools of thought”.
- Absence of **history of thought** is a fair criticism.
- Has led to “grass is greener” syndrome where students imagine Austrian, Marxist or Post-Keynesian economics have lots of answers that their mainstream courses do not. Alas, this isn’t really the case.
- Do other fields devote large amounts of course time to approaches most academics view as being of limited use?
- Trade-off between giving a better historical perspective on the subject versus teaching other valuable things.

# Economists: A Report Card

- Many criticisms are misguided or over-stated.
- But serious problems exist all the same
  - Too little engagement with the real world in the classroom and limited incentives for changing teaching methods.
  - Insufficient debate about methodologies economists use.
  - Reward culture for academics that prioritises complex publications over simple but practical applications.
  - Limited role for public engagement in policy issues in university promotion systems.
  - Difficult to challenge prevailing management views in large organisations such as Central Banks and Finance Departments. Hard to get projects focused on new risks off the ground.

# Irish Economists: Not Covered in Glory

- Much of the above applies to Irish economists.
- Prior to the crash, most were working in niche areas and paid little attention to macroeconomic or financial imbalances.
- Among the (very small) number of macroeconomists, the fraction issuing warnings was higher than you'd imagine.
- But too much comfort given by “recency bias” and “Irish exceptionalism” (It'll never happen here).
- Insufficient attention paid to factors underlying a sustainable growth rate or to the dangers of the dominant role construction played in the economy.
- And too much self-censorship and acceptance of politicised thinking inside CBI and DoF.

# Irish Economists: Doing Better?

- Reasons to be positive
  - Much more involvement by university academics in public debate about policy issues.
  - Use of blogging and social media making it easier for new entrants to get their views aired.
  - Somewhat better engagement and dialogues between government and outside economists (e.g. Central Bank and DoF events and through the Fiscal Council).
- But underlying academic incentive systems have not changed much.
  - Warning about macro or financial crashes is not part of any Irish economist's "day job" description.
  - Rewards for public engagement still very limited.