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An Open Letter to Paul Krugman

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Dear Paul:

I was reading your article [How Did Economists Get It So Wrong](#). Who are these economists who got it so wrong? Speak for yourself kemo sabe. And since you got it wrong - why should we believe your discredited theories?

It is a sad fact that whenever something bad happens people will claim that it means that they were right all along, and other people will listen to them. A professional prosecutor frustrated by the fact that you can't beat confessions out of suspects? Wait until September 11 and try again and this time call it the "Patriot Act." A progressive who would like to see higher taxes and more government programs? Wait until there is an economic crisis and call it a "fiscal stimulus bill." Here we are, the recession is over and we've spent 10% of the money...Not the 200% you thought we needed to end the recession.

It is a daunting task to bring you up to date on the developments in economics in the last quarter century. I know that [John Cochrane](#) has tried to educate you about what we've learned about fiscal stimulatae in that period. But perhaps a I can highlight a few other developments? You seem under the impression that economists had resolved their internal disputes before the financial crisis. So that means you haven't followed the [debate](#) about the causes of depressions between Peter Temin on one side and Timothy Kehoe and Ed Prescott on the other? You say that we think that the "central problem of depression-prevention has been solved." Has it not? Are you forecasting that this recession will turn in to a depression? But of course "More important was the profession's blindness to the very possibility of catastrophic failures in a market economy." That would be the profession that hasn't been reading what the profession has written? Perhaps you should go look at that controversial book [Kehoe and Prescott \[2007\], Great Depressions of the 20th Century](#). Or you might read [Sargent, Williams and Zhao \[September 2008\], "Conquest of Latin American Inflation"](#). Wouldn't it be nice if people had some idea of what was being written before criticizing it?

Let us talk more seriously about the supposed failure of the economics profession. You say "Few economists saw our current crisis coming, but this predictive failure was the least of the field's problems." The predictive failure is not a problem of the field - it is a problem for those who are under the impression that we should be able to predict crises. Do you number yourself in this bunch? Do physicists get it wrong because their theory says that they cannot predict where a photon shot through a sufficiently narrow slit will land? Economic models are like models of photons going through slits. Just as those models predict only the statistical distribution of photons, so our models only predict the likelihood of downturns - they do not predict when any particular downturn will occur. Saying "most economists failed to predict the downturn" is exactly like saying most physicists failed to predict the impact of the twelfth photon passing through the slit.

More to the point: our models don't just fail to predict the timing of financial crises - they say that we cannot. Do you believe that it could be widely believed that the stock market will drop by 10% next week? If I believed that I'd sell like mad, and I expect that you would as well. Of course as we all sold and the price dropped, everyone else would ask around and when they started to believe the stock market will drop by 10% next week - why it would drop by 10% right now. This common sense is the heart of rational expectations models. So the correct conclusion is that our - and your - inability to predict the crisis confirms our theories. I feel a little like a physicist at the cocktail party being assured that everything is relative. That isn't what the theory of relativity says: it says that velocity is relative. Acceleration is most definitely not. So were you to come forward with the puzzling discovery that acceleration is not relative...

Of course some people did predict the crisis. Some might even have been smart enough to know that if they consistently predict the opposite of a consensus point forecast, eventually they will be right when everyone else is wrong. If I say every year: there will be war; there will be an asset market crash; there will be a recession; there will be famine; we will run out of oil - eventually I'll be right. These kind of predictions are only meaningful if more people than can be attributed to random good luck got it right at the right time or if whatever method they used to reach that conclusion is replicable. Or does the ability to replicate results fall under the category of "not very interesting because that would be an elegant theory?"

But let's turn to what you say are our deeper failures. We "turned a blind eye to the limitations of human rationality that often lead to bubbles and busts." It makes me feel physically ill that a distinguished economist could be so ignorant of his own profession. As a random example, [how about my student Felipe Zurita's thesis on speculation written in 1998?](#) There are endless papers written about bubbles and busts - some assuming rationality, some not. Some are experimental, some are theoretical, some are empirical. There are economists who have devoted their entire careers to studying bubbles. There is a fellow named [Stephen Morris](#). He isn't what you would call a fringe member of the economics profession - he's the editor of *Econometrica* which, as you know, is one of the leading journals in economics. He has written extensively about bubbles. I take it you aren't familiar with his work. Perhaps you should walk down the hall and stick your head in his office and ask him about it? Each crisis - in Mexico, in South-east Asia, in Argentina - had generated hundreds of papers examining how and why the crisis took place.

Efficient markets? Where have you been for the last quarter century? The modern theory of how financial markets incorporate information is that they do so imperfectly. The technical device is that of noise traders originating in a 1985 paper of Admati. But I think you knew of the idea earlier. In 1980 when you were a visitor at MIT, you participated in a graduate student seminar...in which I presented a paper starring noise traders...

Do we really need some sort of behavioral model to understand why asset prices fall abruptly? If opinions about asset values change, prices must fall abruptly - it isn't irrational to run for the exits when the theater is on fire. In addition to a beautiful 1983 paper of Steve Salant there is a large literature on bank runs and contagion, not to speak of credit and collateral cycles. If there was some sort of irrationality involved in a panic, prices ought to bounce right back the next day when everyone wakes up and sheepishly realizes that they were wrong. In fact asset prices seem to be tracking news of fundamentals pretty well - gradually recovering as we get better news about fundamentals.

Has behavioral economics offered anything that would help to solve the market failures that characterized this crisis? Was it herd behavior or animal spirits? Or was it risks that were not being priced? Serious economists like [Lasse Pedersen](#) try to analyze how liquidity risks created systemic problems and think about how to incorporate them into our understanding of how to ameliorate future crises. They don't shake their heads and revert to discredited static theories of the 1930's.

Crises have been ubiquitous throughout history. While we can't forecast them we do know how to learn from them. And we certainly have a good idea what not to do in response: do what Chile did successfully - fail banks and recycle them, not do what Japan did unsuccessfully - keep the zombie banks limping feebly around. Like me you saw the bank bailout plan for what it was - not a necessary step to save the credit sector from collapse but a give-away of taxpayer money to investment bankers. But the stimulus plan? How can you be arguing for more? Since we are recovering before most of the stimulus money has entered the economy - isn't that evidence it isn't needed? How can you write as if you are proven right in supporting it?

Regards,

David

[Thanks to Tom Cooley for talking this through.]

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