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Economics and Its Discontents

In the aftermath of the worst scare since the 1930s, economists have identified a new culprit to share the blame for the subsequent mess – themselves, or rather those among their tribe with whom they disagree. No longer are greedy Wall Street bankers, feckless regulators and a blasé Federal Reserve Board the only suspects. The economics profession has joined them in the dock.

“How Did Economists Get It So Wrong?” asked Paul Krugman last week in *The New York Times Magazine*. “The Financial Crisis and the Systemic Failure of the Economics Profession,” wrote David Colander, Alan Kirman and several others in *Critical Review*.

“The Other-Worldly Philosophers,” offered the headline of thoughtful examination in *The Economist* two months ago. On its cover, a textbook – “Modern Economic Theory” – melted into a puddle. The editorial began, “Of all the bubbles that have been pricked, few have burst more spectacularly than the reputation of economics itself.”

Is that really true? Or is the hubbub another case of what Sigmund Freud, in [Civilization and Its Discontents](#), termed “the narcissism of small differences” – the tendency to exaggerate the dissimilarities of those who resemble us in an effort to buttress our own self-regard?

Since the controversy is mainly a renewal of hostilities among the New Classical and New Keynesian schools that flared fiercely in the 1970s and '80s, supplanting the antagonisms among Monetarists and Old Keynesians before settling down to an uneasy backseat truce the '90s and '00s (dubbed, if you can believe it, “the new neoclassical synthesis”), there is some reason to suspect that psychopathology is the real problem

The fireworks, as usual, have been provided by Krugman, *New York Times* columnist, Princeton professor and winner of last year's economics Nobel Prize.

Forty years ago, he wrote, economics had divided into two great factions, purists and pragmatists, meaning New Classicals and New Keynesians (or [freshwater and saltwater economists](#), in Robert Hall's memorable phrase, which characterized the neighborhoods of the universities in which the various parties tended to work).

The purists, led by Robert Lucas, Thomas Sargent and Edward Prescott, favored ingeniously-constructed mathematical models, disparaged Keynes, doubted that business cycles can be cured by policy (other than steady monetary growth and credible policy actions to control inflation).

The pragmatists, including Olivier Blanchard, David Romer and N. Gregory Mankiw, inherited from Keynes the belief that market failure is at the center of the business cycle, and built their own style of mathematical models to relate that failure to individual behavior in setting wages and prices. They remained convinced that policy could combat recessions.

Lulled by the success of central bankers Paul Volcker and Alan Greenspan – the quarter-century of steady growth and low inflation over which they presided has been dubbed “the Great Moderation” — the pragmatists gradually abandoned the Old Keynesian faith in activist fiscal policy (although they continued to argue among themselves over whether the smooth sailing stemmed from good monetary policy or from a series of positive developments in the economy itself).

Gradually, even the pragmatists traded their customary wariness for triumphal confidence that monetary policy alone was adequate to tame the business cycle – until last year, when the housing bubble and its counterpart sub-prime crisis gave way to panic when a large investment bank, Lehman Brothers, was allowed to fail. That development, a year ago, took almost all macroeconomists completely by surprise, purists and pragmatists alike.

“Neither side was prepared to cope with an economy that had gone off the rails despite the Federal Reserve Board's best efforts,” wrote Krugman, though he acknowledged, far down in his article, that policy makers seem to have muddled through. (“Cross your fingers,” he wrote.) For economics itself, he concluded, there was nothing for it now except to admit that, “after several revolutions and counter revolutions, Keynesian economics remains the best framework we have for making sense of recessions and depressions.” The article was accompanied by a series of even more forceful cartoons.

A more temperate version of the same story was offered by Robert J. Gordon, of Northwestern University, earlier this summer at the International Colloquium on History of Thought in Sao Paulo, Brazil. For those interested in the history of the freshwater-saltwater controversy, [his account](#) makes fascinating reading.

Gordon offers to relinquish the “Keynesian” adjective to describe the present-day pragmatist (or saltwater tradition) in recognition that this nomenclature was tainted in the ’70s, in large part due to the success of New Classical purists to link it to the failed Phillips Curve, with its one-way tradeoff between unemployment and inflation. Instead, he proposes to substitute “1978-era macro” to describe the pragmatist point of view. A new generation of models, developed to describe supply-side responses to the OPEC shocks as well as traditional demand-side effects, was introduced in two path-breaking intermediate texts that appeared that year, one by Rudiger Dornbush and Stanley Fischer, both of the Massachusetts Institute of Technology, the other by Gordon himself. They contain virtually all the tools necessary to understand the crisis of 2008, he says.

The reasoning is more delicate than Krugman’s article; the survey of the relevant work more even-handed and generous. And he traces some important similarities between the bubbles of 1927-29 and 2003-06. But in the end, Gordon makes the same point as Krugman: to understand what happened in the US during the 2007-09 worldwide crisis, “we are best served by applying 1978-era macro and forgetting most of the modern macro that has developed since.” He concludes, “Empirical success and common sense have triumphed over the endless search for deep microfoundations in a world in which macroeconomic interactions triumph over individual choice.” He means that wage earners don’t choose to leave their jobs and firms to shut their plants in a recession, in order to enjoy more free time (the caricature implied by purists’ models); instead they are the victims of the coordination failures that occur when financial crashes spill over to the demand for products, and from there to layoffs and unemployment.

That is almost certainly true. But neither is it the whole story. The search for microfoundations may not have turned up much to brag about in the investigation of recessions and unemployment, but it has paid off handsomely in other fields, such as monetary theory and the economics of growth. It may yet tell us something worth knowing about public finance, and even produce a good strong model of the relationship of banking and finance to the real economy. (Almost everyone

agrees that's what's needed now.) There is no reason to think that the purists should abandon their quest.

But then there is no reason to turn to them for policy advice. For once, there is strong evidence that, with the pragmatists, we're in good hands. Consider, for example, [the performance of the Israeli economy](#), where arch-pragmatist Stanley Fischer is head of the central bank. A veteran of the Asian and Russian financial crises – during which he was deputy managing director of the International Monetary Fund – Fischer was quick to act when the global economy abruptly stalled last year. He slashed interest rates and conducted a modest competitive devaluation. Now Israel's export-driven economy is expected to grow by 3.3 percent next year. A single country, yes, but significant as was the performance of the Swedish economy (on similar grounds) in the early 1930s.

More to the point is the current situation in the United States, where another arch- pragmatist, Ben Bernanke, has assumed control, and where the economy apparently is beginning to grow again. Unemployment is still rising; job growth next year is expected to be painfully slow: the recession will go into the record books as the worst since World War II. The seven major economies of Europe are growing again, according to the Organization for Economic Cooperation and Development, as are those of China, India and Russia. On the evidence so far, it is Robert Lucas, not Paul Krugman, who has been more nearly correct: the central problem of depression-prevention apparently *has* been solved.

By no means is it time to sound the All Clear. But broadly speaking, economics has served us well in understanding and managing the crisis — microeconomics in understanding the myriad mismatched incentives that produced it; battle-tested pragmatic macroeconomics in managing it, so far. Taking the saltwater/freshwater battle back to the public won't help. Freud wrote *Civilization and its Discontents* in part to explain the persistence of ethnic strife. Never mind the narcissism of small differences. The last thing we need is a civil war in economics' equivalent of the Balkan states, the fractious province of Macro.

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