

# BusinessWeek

COVER STORY April 16, 2009, 5:00PM EST

## What Good Are Economists Anyway?

Why they failed to predict the global economic crisis—and why their help is still crucial to a recovery

By [Peter Coy](#)

Economists mostly failed to predict the worst economic crisis since the 1930s. Now they can't agree how to solve it. People are starting to wonder: What good are economists anyway? A commenter on a housing blog wrote recently that economists did a worse job of forecasting the housing market than either his father, who has no formal education, or his mother, who got up to second grade. "If you are an economist and did not see this coming, you should seriously reconsider the value of your education and maybe do something with a tangible value to society, like picking vegetables," he wrote on patrick.net.

Take that, you pointy-headed failures! Go jump off a supply curve!

To be fair, economists can't be expected to predict the future with any kind of exactitude. The world is simply too complicated for that. But collectively, they should be able to warn of dangers ahead. And when disaster strikes, they ought to know what to do. Indeed, people pay attention to economists at times like this precisely because of their bold claim that they know how to prevent the economy from sliding into a repeat of the Great Depression. But seven decades after the Depression, economists still haven't reached consensus on its lessons. The debate has only intensified in recent weeks.

To fight the downturn, Federal Reserve Chairman Ben Bernanke, Treasury Secretary Timothy F. Geithner, and National Economic Council Director Lawrence Summers are attempting an unprecedented combination of massive fiscal stimulus and extreme monetary policy. If it produces a sustained recovery—and there are some early signs of hope—they will look like heroes. For now, though, it's disturbing that they've had to resort to policy measures that in scale and scope are way outside what the economics profession had studied or even contemplated in recent years.

The rap on economists, only somewhat exaggerated, is that they are overconfident, unrealistic, and political. They claim a precision that neither their raw material nor their skill warrants. Too many assume that people behave like the mythical homo economicus, who is hyperrational and omniscient. And they take sides in quarrels that freeze the progress of research. Those few who defy the conventional wisdom are ignored.

Critics are scathing. Nassim Nicholas Taleb, the scholar of rare events who wrote *Foiled by Randomness* and *The Black Swan*, says: "We have to build a society that doesn't depend on forecasts by idiotic economists." Says Paul Wilmott, a quantitative finance expert: "Economists' models are just awful. They completely forget how important the human element is."

In the face of such withering criticism, it's tempting to ignore the whole profession. But that won't do. For one thing, getting out of this mess and making sure it doesn't happen again will require the very best thinking of a generation. Macroeconomists—that is, those who specialize in business cycles and growth—have made

important contributions. For example, research in the 1970s helped many countries eliminate chronic high inflation by highlighting the importance of having a strong, independent central bank.

Even now, progress is being made. Scholars of all stripes are belatedly getting up to speed in modern finance. Because they are trained to think of financial markets as efficient, most economists weren't primed to spot the dangers posed by lax mortgage lending, overleveraged financial institutions, and impenetrably complex derivatives. "The time is absolutely right for

new ideas to come in, much as they did in the 1930s and the 1970s," says Roger E.A. Farmer of the University of California at Los Angeles.

Besides, even if you're suspicious of economists' value, they are impossible to ignore. Here's why: Every idea you can think of for coping with this crisis is based on some supposition about the way the world works. Whether you realize it or not, all of those suppositions come out of one school of economics or another. As the British economist John Maynard Keynes wrote: "Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist."

So we had all better hope that the profession can get its act together. It won't be easy, because this crisis is rubbing salt in old wounds. It is reopening debates about one of the most contentious questions in macro, namely, the ability of government deficit spending (i.e., fiscal policy) to stimulate demand and get people back to work.

In January the fight over fiscal policy broke out in public after then-President-elect Barack Obama made what probably seemed to him a safe claim, saying: "There is no disagreement that we need action by our government, a recovery plan that will help to jump-start the economy." Not long after, some 250 conservative economists, in an open letter published in major newspapers, wrote: "With all due respect Mr. President, that is not true." Middlebury College economist David C. Colander, who himself is suspicious of the stimulus package, says: "The debate is reasonable. What's unreasonable is that we're undertaking it at this time" rather than decades ago.

Economists' worst sin is hubris. In the 1960s, free-market economist Milton Friedman persuaded virtually the entire profession that the Great Depression was caused by the Federal Reserve. That seemed to imply that better policy by the Fed, guided by economists, would prevent a recurrence. Bernanke, then a governor of the Federal Reserve, said as much in a 2002 speech for Friedman's 90th birthday that acknowledged the Fed's role in the Depression. He told Friedman: "You're right, we did it. We're very sorry. But thanks to you, we won't do it again." Famous last words.

Believing in the power of the Fed, economists mostly stopped researching the use of fiscal policy to fight recessions or depressions. What's more, recessions had become rarer and milder—the so-called Great Moderation. So who needed stimulus? Says New York University economist Xavier Gabaix: "Up until a year ago, you would look very old-fashioned if you were talking about optimal fiscal policy."

Mainstream economists' adherence to orthodoxy was also apparent in their casual dismissal of worries about bubbles in housing and stocks. Former Fed Chairman Alan Greenspan denied that a national housing bubble was even possible, since housing was not a single national market. He also brushed off the dangers of Wall Street concoctions such as derivatives. Only last year did he concede he was wrong. In Senate testimony, he said he was shocked to have found a "flaw" in his ideology, adding: "I have been going for 40 years or more with very considerable evidence that it was working exceptionally well."

Politics compounded the trouble. As a rough first cut, you can divide macroeconomists based on how concerned they are about economic instability. One group, in the tradition of Keynes, worries about self-perpetuating economic declines that leave the economy in a deep trough it can't escape. Members of this group say government needs to break downward spirals with the kinds of aggressive policies the U.S. is following now—cutting interest rates and raising government spending. The group includes Paul R. Krugman, the Princeton University economist and Nobel laureate; NYU's Nouriel Roubini, who was early in predicting a severe recession; and Yale University's Robert J. Shiller, who predicted the housing bust and the tech-stock bust.

Other economists have more confidence that the economy is self-equilibrating. They believe low interest rates and heavy deficit spending will be ineffective while leaving the U.S. with a mountain of debt. Count Harvard's Robert Barro in this camp, along with Chicago's Robert E. Lucas Jr., Arizona State University's Edward C. Prescott, and the University of Minnesota's Patrick J. Kehoe and V. V. Chari. No surprise, the equilibrium school mainly leans Republican, and the interventionist school seems to be crawling with Democrats.

Before this crisis, it seemed that economists might resolve their differences. The oft-combative Krugman, in the first edition of his textbook *Macroeconomics* in 2006, wrote that "the clean little secret of modern macroeconomics is how much consensus economists have reached over the past 70 years."

The mood now is uglier. On the left, Krugman says: "This is really fairly shameful, that we should be wasting precious months as a profession retracing debates that were settled 70 years ago." On the right, John H. Cochrane of the University of Chicago dismisses those who advocate Keynesian stimulus, saying: "Professional economists, the guys I hang out with, are not reverting to ancient Keynesianism any more than physicists are going back to Aristotle when they can't understand how fast the universe is expanding." There are some middle-of-the-roaders, such as Columbia University's Michael Woodford, who argue that macroeconomists are converging on a methodology for asking questions. But even Woodford agrees that "recent debates don't particularly make the field look unified."

The easiest criticism of macroeconomists is that nearly all failed to foresee the recession despite plenty of warning signs. In early September 2008, the median growth forecast for the fourth quarter was 0.2%, according to a survey by *Blue Chip Economic Indicators*. The actual outcome was a 6.3% annualized decline. The Fed didn't do any better. In July 2008, Fed officials projected unemployment in the fourth quarter of 2008 would end up between 5.5% and 5.8%. The actual number was 6.9%. Their projection for the fourth quarter of 2009, done at the same time, was for a range of 5.2% to 6.1%. Today, with unemployment at 8.5%, most forecasters expect the rate to be nearing double digits by the end of 2009.

Now that fiscal policy is back on the table, economists are fighting over the size of the ripple effect—or "multiplier"—of increased government spending. Interventionist economists think multipliers are large when the economy is operating below capacity—and it certainly is now. According to a Fed report on Apr. 15, one-third of manufacturing's productive capacity is going unused, the biggest share on record back to 1948.

Obama Administration officials believe that their fiscal policy is on the right track. The stimulus program "is putting a little more energy into the consumer," National Economic Council Director Summers told Maria Bartiromo. "Two months ago you couldn't find anything positive." Christina D. Romer, Obama's chief economic adviser and a historian of the Depression, said in March that "at some point, recovery will take on a life of its own." Until then, she said, government should watch closely "to make sure the private sector is back in the saddle" before easing off.

Other economists say increased government spending may actually depress private employment. At a Council on Foreign Relations event on Mar. 30, Chicago's Lucas called the Administration's multiplier math "kind of schlock economics."

The truth is, even backers of stimulus can't be sure it will work. As World War II ended, many economists worried that growth would lapse as military spending fell. Sewell Avery, the CEO of Montgomery Ward, was so anxious about a postwar depression that he refused to open new stores. Economists still aren't sure why he was wrong, so they can't say reliably whether fiscal stimulus will end this recession or just interrupt it. "Is it possible to engineer a durable recovery with fiscal expansion, or are you just buying time?" asks Krugman, who favors coupling stimulus with drastic action to fix the banks.

What, then, is the way forward? Once this crisis is past, the next agenda for macroeconomists will be to help make the economy far more robust—enough to survive the blunders of politicians, bankers, and economists of the future. Taleb, the scholar of unpredictability, notes that nature achieves robustness through a redundancy that economists would consider wasteful: two hands, two eyes, etc. Blake LeBaron of Brandeis University suggests preventing huge crises by tolerating small disturbances, the way foresters use controlled burns to eliminate flammable underbrush. Perhaps out of the ashes of failure will emerge a better macroeconomics profession.

*With Jane Sasseen and Theo Francis*

## **BUSINESS EXCHANGE: READ, SAVE, AND ADD CONTENT ON BW'S NEW WEB 2.0 TOPIC NETWORK**

### **New Priorities**

In a Mar. 12 blog post, economist Arnold Kling predicts that in the future macroeconomists will be less concerned about monetary policy and more focused on financial institutions and regulatory policy. One area of study, says Kling, should be "what, if anything, the government can do to prevent episodes of over-confidence or under-confidence in financial institutions." Too little confidence creates a lending drought, while too much leads to bubbles, he argues.

To read Kling's post, go to <http://bx.businessweek.com/economic-analysis/reference/>

[Coy](#) is BusinessWeek's Economics editor.

The McGraw-Hill Companies