

September 10, 2009

## Economists got it wrong, but why?

Economists definitely received some bad publicity this past week, most prominently in the *New York Times*, where Paul Krugman asked "[How Did Economists Get It So Wrong?](#)," a nonrhetorical question he goes on to answer this way:

"As I see it, the economics profession went astray because economists, as a group, mistook beauty, clad in impressive-looking mathematics, for truth... the central cause of the profession's failure was the desire for an all-encompassing, intellectually elegant approach that also gave economists a chance to show off their mathematical prowess.

"Unfortunately, this romanticized and sanitized vision of the economy led most economists to ignore all the things that can go wrong. They turned a blind eye to the limitations of human rationality that often lead to bubbles and busts; to the problems of institutions that run amok; to the imperfections of markets—especially financial markets—that can cause the economy's operating system to undergo sudden, unpredictable crashes; and to the dangers created when regulators don't believe in regulation."

For at least one part of the Krugman critique, I have some sympathy. On the occasion of a [2005 conference honoring the 25th anniversary of Chris Sims's pathbreaking article "Macroeconomics and Reality"](#)—an article that was itself a critique of empirical practices then dominant in central banks—I [had this to say](#) about the dangers of groupthink and questions we might be missing as a consequence:

"We are close to falling dangerously in love with the basic New Keynesian framework, the sticky price aspects of it in particular. Here is a simple observation: In the [statistical models] that are identified in the usual ways, inflation wants to drop like a rock in response to a basic technology shock. Models that engineer significant price inertia don't want to let that happen...

One final point. In my time at the Fed, I have come to appreciate that most of the really important policy choices have nothing to do with Taylor rules or the like. They have to do with those episodes of financial crisis in which Taylor-like rules are woefully inadequate. Think here October 1987, the period from summer 1997 through the end of 1998, and the aftermath of September 11, 2001."

Though Professor Krugman spends a lot of time attacking acolytes of the so-called "Chicago" school, the fact is that the New Keynesian framework (described [here](#) by Greg Mankiw) is the workhorse theory within policymaking circles. If economists were unable to see their way to the macroeconomic consequences of the unfolding crisis, criticism needs to start with that framework.

I think such criticism is warranted, but the thrall of the New Keynesian world view has little to do with how "beautiful" the model is or that it is built on a lot of "impressive-looking mathematics." Quite the opposite. As I said in my 2005 comments, "the dynamics of the policy briefing game seem to favor forecasting performance over theoretical integrity." The models that we use for policy analysis are constructed on the basis of what connects with the facts we see (or think we see) in the data. If these models fail to contemplate things that *might* happen, it is precisely because there is a bias toward frameworks that explain *history*.

Robert Lucas zeroed in on this point in his "[defence of the dismal science](#)":

"The Economist's briefing [criticizing the foresight of mainstream economists] also cited as an example of macroeconomic failure the 'reassuring' simulations that Frederic Mishkin, then a governor of the Federal Reserve, presented in the summer of 2007. The charge is that the Fed's FRB/US forecasting model failed to predict the events of September 2008. Yet the simulations were not presented as assurance that no crisis would occur, but as a forecast of what could be expected conditional on a crisis not occurring. Until the Lehman failure the recession was pretty typical of the modest downturns of the post-war period. There was a recession under way, led by the decline in housing construction. Mr Mishkin's forecast was a reasonable estimate of what would have followed if the housing decline had continued to be the only or the main factor involved in the economic downturn."

Some attempts have been made to exploit the information contained in data from the Great Depression. (If you have patience for technical analysis you can find an example [here](#).) And there have been many attempts to jerry-rig existing models to capture the financial shocks and their aftermath, especially once we had seen what that sort of reality looks like. But, by and large, the last year has been a data point we haven't seen before, and it is not so surprising that models designed to capture the average quarter in the economy's life would not do so well when very unaverage events arise.

It is certainly clear that the dominant pre-2007 strain of New Keynesian models was inadequate to the task that would confront us post-2007. That this was the case was not unknown. If I may quote myself again:

"I have in the past agreed that it is useful to think of the policy choices [following financial market events like the stock market crash of 1987] as policy shocks. I would still argue that today. But it sure would be helpful if at least some of these events would appear as something more than completely random disturbances. In other words, it would be very useful to have usable measures of what we loosely call 'financial market fragility,' and more useful still to have a coherent [sophisticated] quantitative model that captures them."

The problem with that prescription was that the relative infrequency of such events would *likely* have required us to step outside of our existing data-driven policy models and apply *more* theory, not less.

So does all this lead to the conclusion that we ought to ditch the presumptions of rationality and (largely) efficient markets, as Professor Krugman suggests? I have my doubts. Even some of the examples in the Krugman article seem to rely on the power of those ideas. In describing the problem of the lower bound of zero on nominal federal funds rates, he says this:

"During a normal recession, the Fed responds by buying Treasury bills—short-term government debt—from banks. This drives interest rates on government debt down; investors seeking a higher rate of return move into other assets, driving other interest rates down as well; and normally these lower interest rates eventually lead to an economic bounceback...

"But zero, it turned out, isn't low enough to end this recession. And the Fed can't push rates below zero, since at near-zero rates investors simply hoard cash rather than lending it out. So by late 2008, with interest rates basically at what macroeconomists call the 'zero lower bound' even as the recession continued to deepen, conventional monetary policy had lost all traction."

That whole story relies on a conventional monetary transmission mechanism, one that fundamentally plays off of efficient markets thinking.

In another passage from the *New York Times* article, we have this:

"I like to explain the essence of Keynesian economics with a true story that also serves as a parable, a small-scale version of the messes that can afflict entire economies. Consider the travails of the Capitol Hill Baby-Sitting Co-op.

"This co-op, whose problems were recounted in a 1977 article in *The Journal of Money, Credit and Banking*, was an association of about 150 young couples who agreed to help one another by baby-sitting for one another's children when parents wanted a night out. To ensure that every couple did its fair share of baby-sitting, the co-op introduced a form of scrip: coupons made out of heavy pieces of paper, each entitling the bearer to one half-hour of sitting time...

"Unfortunately, it turned out that the co-op's members, on average, wanted to hold a reserve of more than 20 coupons, perhaps, in case they should want to go out several times in a row. As a result, relatively few people wanted to spend their scrip and go out, while many wanted to baby-sit so they could add to their hoard. But since baby-sitting opportunities arise only when someone goes out for the night, this meant that baby-sitting jobs were hard to find, which made members of the co-op even more reluctant to go out, making baby-sitting jobs even scarcer...

"In short, the co-op fell into a recession."

That's a great example, but where is the irrationality? That tight monetary policy might cause a downturn in the economy may be absent from purely classical models, but it is dead center of the New Keynesian framework. The problem was that our mechanism for capturing monetary nonneutrality—essentially wage and price stickiness—was far too simplistic to capture the shocks that we were about to face (and that we arguably faced to lesser degrees during past financial market events).

In short, I accept the criticism that the dominant New Keynesian framework for forecasting and economic modeling needs some work (to say the least). I'm less convinced that we require a major paradigm shift. Despite suggestions to the contrary, I've yet to see the evidence that progress requires moving beyond the intellectual boundaries in which most economists already live.

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