

Economics in crisis: It is time for a profound revamp

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There can be little doubt. The science of macroeconomics is in deep trouble. The best and the brightest in the field fight over the most basic problems. Take government budget deficits, which now exceed 10% of gross domestic product in countries such as the US and the UK. One camp of macroeconomists claims that, if not quickly reversed, such deficits will lead to rising interest rates and a crowding out of private investment. Instead of stimulating the economy, the deficits will lead to a new recession coupled with a surge in inflation. Wrong, says the other camp. There is no danger of inflation. These large deficits are necessary to avoid deflation. A clampdown on deficits would intensify the deflationary forces in the economy and would lead to a new and more intense recession.

Or take monetary policy. One camp warns that the build-up of massive amounts of liquidity is the surest road to hyperinflation and advises central banks to prepare an exit strategy. Nonsense, the other camp retorts. The build-up of liquidity just reflects the fact that banks are hoarding funds to improve their balance sheets. They sit on this pile of cash but do not use it to increase credit. Once the economy picks up, central banks can withdraw the liquidity as fast as they injected it. The risk of inflation is zero.

Both camps line up an impressive list of Nobel prize-winners to buttress their arguments. Economists have often disagreed in the past, but this time the tone is different. The protagonists do not hesitate to accuse the other camp of ignorance or bad faith. I have never seen anything like this.

So what? Does it matter that economists disagree so much? It does. Take the issue of government deficits. If you want to forecast the long-term interest rate, it matters a great deal which of the two camps you believe. If you believe the first one, you will fear future inflation and you will sell long-term government bonds. As a result, bond prices will drop and rates will rise. You will have made a reality of the fears of the first camp. But if you believe the story told by the second camp, you will happily buy long-term government bonds, allowing the government to spend without a surge in rates, thereby contributing to a recovery that the second camp predicts will follow from high budget deficits.

Most people are not sure which camp is right. They hesitate. One day, when green shoots are popping up here and there, they believe the story warning about inflation; the next day, when the shoots turn brownish, they believe the other story. Disagreements among economists take away the intellectual

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anchors around which market participants interpret events and forecast the future. Ultimately, all our forecasts use a particular economic model to interpret data and to forecast their future course. The existence of wildly different models takes away this intellectual anchor and this translates into more market volatility.

This conflict matters not only for market participants, but also for policy-makers. The two camps of economists have wildly different estimates of the effect of a 1% permanent increase in government spending on real US GDP over the next four years. According to the first camp, the Ricardians, the multiplier is closer to zero than to one, i.e. 1% extra spending generates much less than 1% of extra GDP, producing little extra tax revenue. Thus budget deficits surge and become unsustainable.

By contrast, the second camp, the Keynesians, predict that the same 1% of extra government spending multiplies into significantly more than 1% of extra GDP each year until the end of 2012. This is the stuff that governments dream of, because such multiplier effects are likely to generate additional tax income so that budget deficits decline.

With so much disagreement, it is no surprise that policy-makers are unsure and vacillate. Some countries, such as the US and France, go all out for the Keynesian story; others, such as Germany, put more faith in the Ricardians. Personally I think the Keynesians are right, but my opinion is irrelevant. The point is that the cacophony of analysis helps to explain why policy-makers react in different ways to the same crisis and why it is so difficult for them to come up with coordinated action.

How to resolve this crisis in macroeconomics? The field must be revamped fundamentally. Some of its shortcomings are obvious. Before the financial crisis, most macroeconomists were blinded by the idea that efficient markets would take care of themselves. They did not bother to put financial markets and the banking sector into their models. This is a major flaw.

There is a deeper problem, however, that will be more difficult to resolve. This is the underlying paradigm of macroeconomic models. Mainstream models take the view that economic agents are superbly informed and understand the deep complexities of the world. In the jargon, they have rational expectations. Not only that. Since they all understand the same truth, they all act in the same way. Thus modelling the behaviour of just one agent (the representative consumer and the representative producer) is all one has to do to fully describe the intricacies of the world. Rarely has such a ludicrous idea been taken so seriously by so many academics. (Other fields of economics have not been deluded by this implausible idea and therefore do not face the same criticism.)

We need a new science of macroeconomics. A science that starts from the assumption that individuals have severe cognitive limitations; that they do not understand much about the complexities of the world in which they live. This lack of understanding creates biased beliefs and collective movements of euphoria when agents underestimate risk, followed by collective depression in which perceptions of risk are dramatically increased. These collective movements turn uncorrelated risks into highly correlated ones. What Keynes called “animal spirits” are fundamental forces driving macroeconomic fluctuations.

The basic error of modern macroeconomics is the belief that the economy is simply the sum of microeconomic decisions of rational agents. But the economy is more than that. The interactions of these decisions create collective movements that are not visible at the micro level.

It will remain difficult to model these collective movements. There is much resistance. Too many macroeconomists are attached to their models because they want to live in the comfort of what they understand – the behaviour of rational and superbly informed individuals.

To paraphrase Isaac Newton, macroeconomists can calculate the motions of a lonely rational agent but not the madness of the crowds. Yet if macroeconomics wants to become relevant again, its practitioners will have to start calculating this madness. It is going to be difficult, but that is no excuse not to try.