

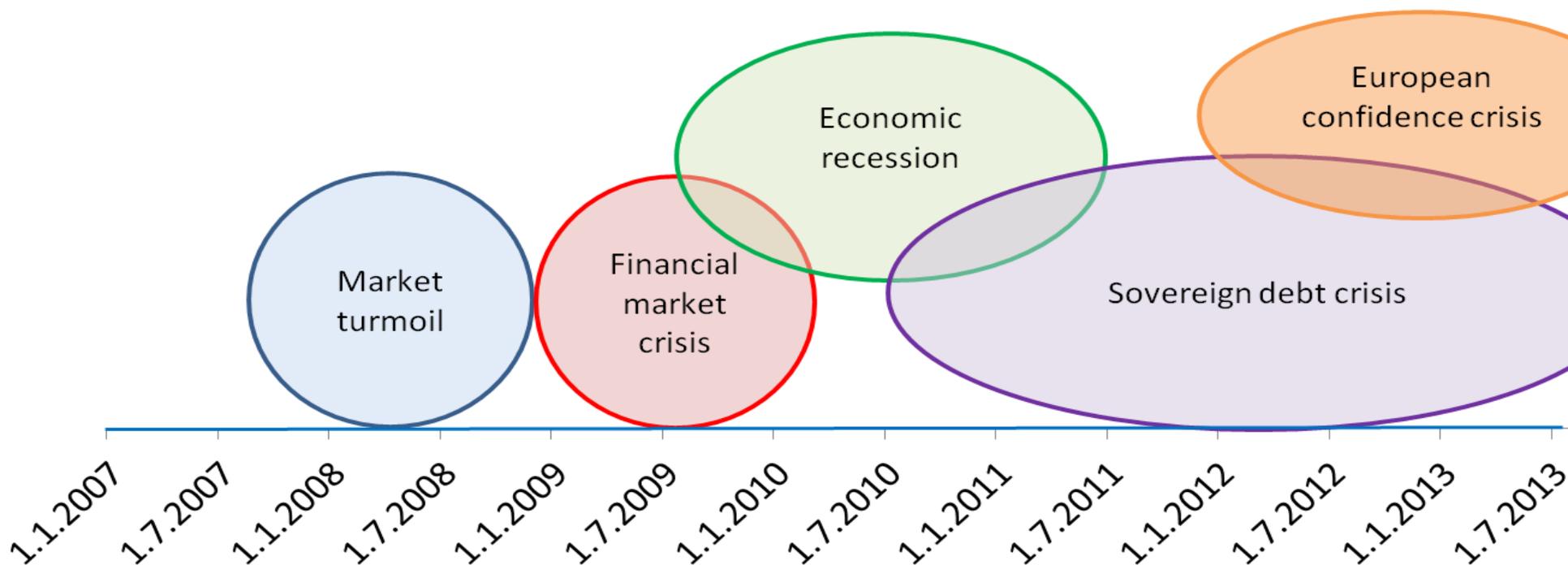
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# Economics after the financial crisis: Comments

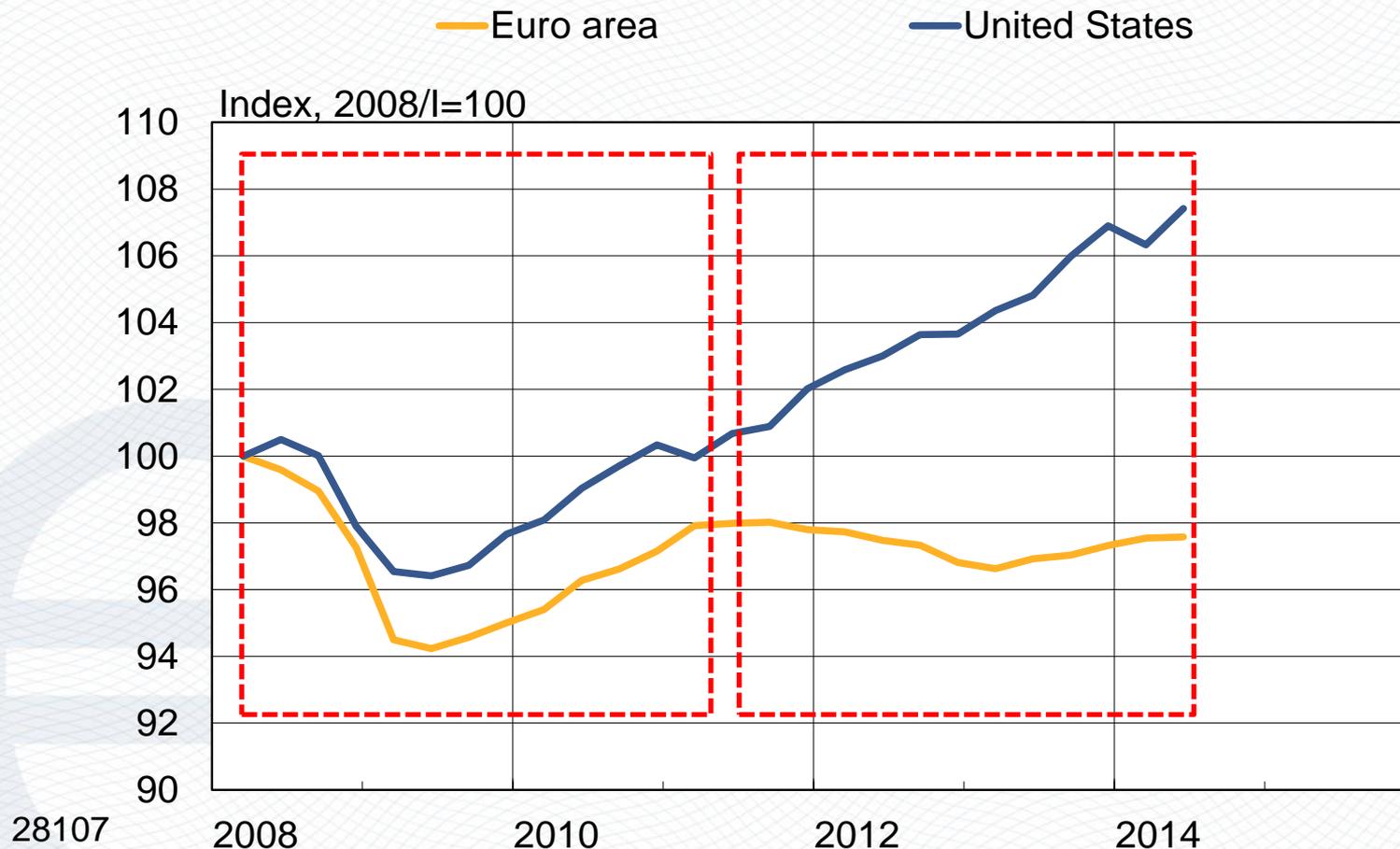
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# Phases of the European financial market crisis



# Euro area experiencing a double-dip recession: GDP developments



Source: Macrobond and the calculations by the Bank of Finland.

# I. Introduction

- I received the presentation only on Sunday evening.
  - I start with my personal view on the state of economics after the financial crisis.
  - I then give comments on the presentation.
- Before starting I should indicate my background.
  - I was an academic until 7 years ago when I joined BofF.
  - My last academic post was Professor of international macroeconomics, University of Cambridge.
  - My main research has been outside the mainstream of economics for nearly 30 years.
    - I also have some research that can be called mainstream.

## II. Financial crisis exposed serious problems in economics

- The crisis was not sufficiently foreseen by economists.
  - Some economists warned about it, in particular Raghuram Rajan in 2005.
- Financial fragility and crises was not in the economics curriculum of many universities.
  - But some universities covered the subject. (I taught it in a course on banking and monetary policy since 2005.)
- More generally, economic history should have had a much bigger role in economics teaching.
- Also history of economic thought should be a part.

# Problems, continued

- Two major areas were greatly affected.
- **Finance**, especially efficient markets theory.
  - But finance has many other viewpoints:
    - Emphasis on consequences of asymmetric information (moral hazard and adverse selection).
    - Behavioral finance, high volatility etc.
- **Macroeconomics**; two different problems in mainstream or rational expectations (RE) approach.
  - Far too little emphasis on financial market imperfections.
  - RE viewpoint downplayed role of imperfect information/knowledge.
    - Big role in short to medium run dynamics in turbulent times.

# III. Some developments in macroeconomics

- Emphasis on financial market imperfections, near zero interest rates policy regime, etc.
- Recent analytical alternatives to mainstream RE macro.
  - Expectations formation under imperfect knowledge: learning, costly information (rational inattention), etc.
  - Bounded rationality, behavioral macroeconomics, experimental macroeconomics, etc.
  - Greatly increased emphasis on empirical research.
- Older schools of thought continue to exist: Evolutionary economics, Austrian economics, post-keynesian economics etc.

# IV. Improving the study of economics

- Better knowledge and understanding of economic history and institutions.
  - Better knowledge of different schools of thought.
  - Much greater focus on empirical research.
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- But study of economics is not about selecting one's philosophy of life (or religion).
    - Economic research moves forward like any other science or discipline. This must happen in broad and flexible ways.
    - Success is measured by improvement in empirical and theoretical explanation of economic phenomena.

# V. Critical comments on the presentation and "the movement"

- I am in broad agreement about misplaced emphasis in economics curriculum.
- I am critical of what is suggested.
- The presentation only describes a straw man of mainstream economics. It is **very misleading**.
  - Is this approach lack of knowledge or bordering on intellectual dishonesty?
- I pick **some examples**:
  - "society, institutions, social norms ... have no role in such an analysis" (slide 7).
    - Examples: models of collective bargaining, insider-outsider theory (Lindbeck & Snower 1988) etc. in mainstream analysis

- "Policymakers should strive to replicate ... would have prevailed under ... optimal setting." This is very misleading for two reasons:
  - Optimal policy corresponds to equilibrium-optimality setting only in straw man versions of the mainstream.
  - Reality is very different from theory. E.g. Fed, BoE, ECB, etc. have had pragmatic responses to the financial crisis.
- Slide 11 misrepresents "orthodox economics": For example, the following topics are much studied in mainstream economics:
  - imperfect information, bounded rationality
  - Production, growth (e.g. endogenous growth, innovations, creative destruction)
  - Regulation of markets (banking, competition, environment, etc.)

- Slide 12: "... no significance of debt relations, no asset price bubbles... ". **Bad misrepresentation** of mainstream.
  - Example: see Jean Tirole (this year's Nobel laureate) 1982 about bubbles by means of mainstream modelling.
- Comment on high financial sector salaries is OK.
  - Also fraud: manipulation of libor rates, exchange rates.
  - Bank bail-outs are a controversial subject. Regulation problems in euro area are being fixed.
  - Cuts in social spending: how about the Greek case with very high CA and public deficits already well before the crisis?
- Slides 17-18 forget the earliest warning by Rajan (2005).
  - I would classify Schiller and Roubini as mainstream.

- Slide 19: Not all wisdom is in old heterodox scholars like Marx, Minsky, etc. Examples:
  - Labor theory of value requires a very extreme assumption.
  - Minsky made a good conceptual point but that is all.
    - Further research, e.g. Eggertsson & Krugman, QJE 2012 (using mainstream approach).
- Slides 25-30 (pluralism etc.): "completely ungrounded superiority of mainstream ..."
  - Of course, ongoing research has some successes but also faces unsolved problems.
  - Describing a straw man of mainstream economics does not prove anything.
    - Need an honest assesment of empirical research results.

- Slide 31 (Central banks...)
  - Haldane's statement is only general statement. It does not take account of ongoing developments.
  - Borio (2013) is a fine scholar on empirics of endogenous cycles but he is not the innovator of endogenous cycles.
    - Shell, Cass, Grandmont etc. developed the theory using mainstream tools but assumed incomplete markets.
- The real challenge for heterodox economics:
  - Demonstrate good performance in empirical and theoretical explanation of economic phenomena.
  - This must be done with models that do not use very narrow and unrealistic assumptions.

- Final slide:

- Attempts to have political influence on social sciences including economics are a serious concern.
- These attempts come not only from conservatives but also from other political movements, including the left wing.
- History is full of examples about harmful influences from politics hampers progress.
  - Students are especially at risk here.