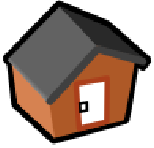

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How the economists got it wrong

- Les Textes - Enseignants et Auteurs - Autres textes sur l'enseignement de l'économie -

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The American Economic Association (AEA) met January 7-9 in Boston, for a millennial program distinguished by its attention to international policy issues, most particularly financial crises (as in Asia) and the failure of the so-called "economic transition" (as in Russia).

And yet, in this odd rush to relevance, something was curiously awry. Apart from a panel including former World Bank chief economist Joseph Stiglitz, the meetings featured almost no one with a record of criticizing the institutions that gave us the Asian crisis or the transition failure. Instead, they were dominated—in session after session—by the architects of the present world order, including Yeltsin advisers Andrei Shleifer and Anders Aslund, the International Monetary Fund's Stanley Fischer, and U.S. Treasury Secretary Lawrence Summers. Even the arch-speculator Myron Scholes appeared. Never, perhaps, has such a luminous crowd gathered to discuss so disastrous a set of its own failings.

Equally striking, from the larger intellectual standpoint, was the lack of retrospective in this year 2000 program of the AEA. The great issues of economic policy—inflation and unemployment, economic growth and stabilization, the government's budget, inequalities of income and wealth—were missing. The central themes of economic theory, including markets and market structure, competition and monopoly, efficiency and equity, and the business cycle, were to be found only in sessions devoted to narrowly defined applied cases. Reading through paper titles, one finds no mention of John Maynard Keynes, Adam Smith, or Karl Marx, or even of Paul Samuelson or Milton Friedman. Samuelson himself appeared once, to give a brilliant short lecture on "The Golden Virtue of Eclecticism"—but to the institutionalists rather than the mainstream.

Missing Ideas

So what is modern economics about? It seems to be, mainly, about itself: The AEA meets to celebrate the importance of its members, their presence in high public positions, their influence in foreign lands, and the winning of the Nobel Prize. Female and black members have won the right to organize sessions about gender and race—thus domesticating some of those who might otherwise complain. Radicals and Keynesians, on the other hand, appeared only on panels organized separately, by an alphabet soup of splinter associations. What was therefore most conspicuously missing from this meeting of America's premier social science organization, was any actual discussion of economic ideas.

But what am I thinking? Of course they don't want to discuss ideas. Would you, with the record of this professorate? Consider what has happened, in recent years, to five of the leading ideas of modern economics.

1. Inflation is everywhere and always a monetary phenomenon. This dictum is the most famous single thought associated with Milton Friedman. It was once, briefly in the early 1980s, the driving philosophy of the Federal Reserve. Its architect, and many of his students, have won the Nobel Prize. But in practice, monetarism has been completely, silently abandoned. Measures of money (notably M2) have been growing rapidly for years, with no inflationary effect. Monetarism as such is, today, an academic dead letter. There wasn't one monetarist topic on the AEA's calendar this year, and a new academic monetarist hasn't emerged in decades.

And yet, the signal policy achievement of the monetarist movement remains intact. Thirty years ago, Friedman-style monetarists wiped out all alternative theories of inflation. The ideas of "cost push" and "wage-price spirals," on which the successful anti-inflation strategies of the 1960s had been based, disappeared. To this day, there exist no alternatives for fighting inflation, except higher interest rates, recession, and unemployment. These are the hard measures, the brutal measures, for which we have the monetarists to thank.

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2. Full employment without inflation is impossible. Four years ago, virtually all "serious" economists, including many self-described Keynesians, agreed: There existed a "natural rate of unemployment." This was in the vicinity of 6 percent, and below it inflation was certain to rise. The number, it turns out, had no basis in serious study; it was first made up by Robert J. Gordon as an illustration for his textbook. Since that time, unemployment has been continuously below 6 percent, without rising inflation. It is now almost exactly 4 percent, the formal target of the Full Employment Act. Faced with the embarrassing facts, only a handful of economists continue to defend the natural rate idea.

And yet, the natural rate movement still influences policy. Some of its survivors vote on the Federal Reserve's Open Market Committee. They are presently driving interest rates upward on precisely the pretext that low unemployment must otherwise soon bring rising inflation. It is a notion for which no evidence exists. And except for the damage that higher interest rates will do, it would be hard not to laugh.

3. Rising pay inequality stems from technological change. "Skill-biased technological change" became in the 1990s the profession's pet rationale for the splitting apart of the pay structure. Translation: The "markets" were rewarding those talented and farsighted enough to acquire new skills, particularly in the computer age. This position is now dismissed by all with a serious grip on the facts. Among other things, the rise in pay inequalities, which had not been timed carefully in the first studies, occurred largely before the wide distribution of personal computers. And the theory cannot account at all for declining pay inequalities after 1994, just when the diffusion of computers and information technologies was speeding up.

And yet, the notion that education can cure the inequality problem remains a staple of economics teaching. It also remains the central policy approach to inequality of "third way" politicians in the United States and Europe, including President Clinton. Once again, conventional policy thought lingers on, even as the research fad has faded out.

4. Rising minimum wages cause unemployment. A furious fight on this issue ensued as recently as 1995 when two distinguished researchers, Alan Krueger of Princeton and David Card of the University of California, Berkeley, broke ranks to declare that the evidence contradicted this thesis. Since then, the minimum wage has gone up twice, and unemployment has continued to decline. Card and Krueger were right—and so was their fundamental criticism of basic labor market theory.

And yet, you will not find more than a grudging acknowledgment of this in economics textbooks, virtually all of which will continue to teach false propositions to new generations of students. Nor have labor market economists thrown their professional weight behind a rising minimum wage.

5. Sustained growth cannot exceed 2.5 percent per year. This lulu was a compound of two errors: the idea that productivity growth was fixed, by mysterious forces, at less than 1.5 percent, and the idea that the growth of the labor force could not long exceed another percent or so. But it turns out that productivity growth picks up when unemployment is low (one entirely sensible reason being that businesses make better use of labor). And it also turns out that there are more potentially employable people out there, after three decades of policy-imposed stagnation, than the economists thought. Even at 4 percent measured unemployment, the economy has been zipping along at 3.5 percent growth or better for several years. In fact, present dangers to growth come very much more from unfounded worries about capacity constraints and labor shortages than from the constraints and shortages themselves.

Economically Correct

The evidence flatly contradicts each of the five dogmas I have just listed. Few economists any longer formally defend

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any of them. As the AEA's year 2000 program showed, these beliefs do not appear on the research agenda of the profession's leaders. But they haven't been abandoned either. They continue to form part of the core ideology of the economics profession, particularly as understood by outsiders. And they equally continue to underpin many economists' interventions in the policy sphere.

Why is this so? The reason is fairly clear. Leading active members of today's economics profession, the generation presently in their 40s and 50s, have joined together into a kind of politburo for correct economic thinking. As a general rule—as one might expect from a gentleman's club—this has placed them on the wrong side of every important policy issue, and not just recently but for decades. They predict disaster where none occurs. They deny the possibility of events that then happen. They offer a "rape is like the weather" fatalism about an "inevitable" problem (pay inequality) that then starts to recede. They oppose the most basic, decent, and sensible reforms, while offering placebos instead. They are always surprised when something untoward (like a recession) actually occurs.

And when finally they sense that some position cannot be sustained, they do not re-examine their ideas. Instead, they simply change the subject. No one loses face, in this club, for having been wrong. No one is disinvited from presenting papers at later annual meetings. And still less is anyone from the outside invited in. Only the occasional top-insider-turned-dissident—this year the admirable Stiglitz—can reliably count on getting a hearing.

No young economist better exemplifies the club spirit than MIT's Paul Krugman. Krugman has once or twice taken useful policy positions—he demolished The Wall Street Journal's effort to deny the rising inequality problem some years back, and he defended capital controls when Malaysia imposed them in 1997. But he has never seriously dissented from the core orthodoxies of his peers. Krugman is concerned, first and foremost, with his own standing among the club's leaders. And he has come to function as a kind of guard dog for their dogma, savagely attacking dim-witted outsiders while remaining generally quiet, if not always completely silent, about acts of illogic committed inside the profession.

Krugman has started a new career as a regular on the op-ed page of The New York Times, and his priorities were on display in his opening column. Consider how it opens:

Beginnings are always difficult: even the most tough-minded writer finds it hard to avoid portentousness. And since this is a quadruple beginning (new year, new century, new millennium, and, for me, new column), I won't even try. What follows are some broad opening-night thoughts about the world economy.

I deliberately say world economy, not American economy. Whatever else they may have been, the 90's [sic] were the decade of globalization... .

And so it goes, one banality after another, grimly through to the end, where Krugman writes that "the facts may be on the side of the free traders ... [but] the opponents are winning the propaganda war." It is a typical Krugman flourish, broad and misleading, in which the economists are pitted against a ruffian fringe. There is not a word to suggest Krugman himself is aware (though he certainly is, having himself come down on the right side) that the key issue among economists is not trade but capital flows.

In a column just a few days later, he is even more explicit: "New challenges to orthodoxy, like the growing backlash against globalization, are already brewing. Such challenges may be ill-informed, but no matter." Always the defense of orthodoxy comes first. Nowhere does Krugman acknowledge the plain fact that the system of free global finance has been in deep crisis for over two years.

Collapse and Denial

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But self-absorption and consistent policy error are just two of the endemic problems of the leading American economists, and not even the most serious among them. The deeper problem is the nearly complete collapse of the prevailing economic theory—of the structure of thought that supports their policy ideas. It is a collapse so complete, so pervasive, that the profession can only deny it by refusing to discuss theoretical questions in the first place.

The prevailing theory is the idea that price and quantity are set in free competitive markets through the interaction of supply and demand. It is this idea, and no other, that lies at the core of the economist's way of thinking. And it is also the source of the profession's problem in getting almost anything important right.

The notion of supply and demand as the organizing principle for everything is a few decades more than a century old. (It was not so for Smith, Ricardo, Malthus, Marx, or Mill.) The key player in the Anglo-Saxon tradition is Alfred Marshall; in the continental tradition, no doubt, Leon Walras. In the twentieth century, great economists including Keynes, Joseph Schumpeter, and John Kenneth Galbraith have tried to break the grip of this notion on the professional imagination. But they have not succeeded.

Supply and demand in the labor market underlies the notion that full employment cannot be reconciled with stable prices, that technological change drives pay inequality, and that raising minimum wages must drive up unemployment. In all these cases, the fundamental theoretical error is essentially the same: It consists in reifying a supply curve, for which no firm empirical foundation exists. Put another way, it consists in allowing a metaphor, one that originates in markets for fish, to govern a profoundly different human institution.

Of course, the collapse of supply and demand perhaps is best illustrated by the global capital markets, which were supposed to bring stable prosperity to the developing countries but instead brought them financial ruin. And nowhere is this more evident, or more catastrophic, than in the case of Russia, where the failure to build new institutions to replace the failing structures of the Soviet system, and the reliance instead on the "market" to provide, has given us a production, employment, and public health disaster, leading toward the reestablishment of a state directed by the secret police and the army. None of this was openly admitted, one can be sure, by the AEA's leaders.

My colleague, the physicist-turned-economist Ping Chen of the University of Texas at Austin and the China Center for Economic Research at Peking University, writes that at the turn of the last century, at the meetings of the Royal Society, Lord Kelvin declared the project of physics to be complete. The twentieth century, he declared, would be dedicated to filling in the details. Within five years, special relativity (and later, quantum mechanics) reduced Kelvin to an amusing footnote.

The reduction of many of today's leading economists to footnote status is overdue. But would those economists recognize a theoretical revolution if one were to occur? One is entitled to doubt it. Being right doesn't count for much in this club.

James K. Galbraith

Post-scriptum :

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