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Rebuilding Economics: Why? And How?

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1. In my 50 years as an economic theorist I faced three basic questions that were answered very badly or not at all in the standard classroom economics. The first of these came up in the 1960s. I was beginning to build intertemporal models of the supply decisions of firms and workers, which are basically investment decisions. My theme – my methodology – was that the decision-makers form *expectations* about what they do not have *information* about; and they form *beliefs* about what they do not have *knowledge* of. Expectations and beliefs are drivers of the economy, not variables to be solved for in a complete analysis.

There was a complication that made modeling these beliefs and expectations challenging. In these models, each entrepreneur contemplates taking an action – for example, to act to acquire more of a business asset, such as employees or customers. In assessing the value (and perhaps the cost) of the action, each will consider, we may assume, what value the others are going to put on the same action. The problem is that, in general, no one can reasonably assume that the *theory* the others will use to make the calculation is the theory that he is going to act on. My solution was to suppose that each entrepreneur moves gradually, revising his prior guiesses as evidence on what the others are doing accuimulates.

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This work of mine and others was “corrected” in the 1970s by the Chicago School with the bold postulate of rational expectations, or RE.[2] The postulate is that people’s beliefs derive from the existing economic theory and people’s expectations can be determined from their situations. Not to suppose that expectations are “rational” is to impute to the actors in the economy an unwillingness to use the best theory available. This would make no more sense than to fail to act on the basis of all the available information. That really would be irrational, they suggested, which we do not want to suppose.

The RE hypothesis did help to test some insights but it was so at odds with some fundamental truths about healthy capitalist economies (of which there used to be a few) that it led to results that misled many unsophisticated economists and nearly the entirety of the world’s banking industry. In any case, there was a resistance movement. A diagnosis of the faults of RE and a “rebuilding” of economics started fairly soon – not last year.

The RE postulate contained two premises. One is that it is *common knowledge* that there is an *agreed-upon* theory. The other premise is that the prevailing theory is the *true* theory and the quantitative elements of it are *known*. In the early 1980s I attacked the first premise. (Roman Frydman attacked the second.) The flavor of my argument is that speculation won’t stop even if all people understand correctly the fundamentals if people suspect that all or most *others* do not subscribe to the same theory. The analysis could be applied to an announcement by the central bank that it

[2] The latter is not the *efficient markets* postulate that people use all information within reach.

was going to stop feeding inflation. The analysis could also be applied to a decline in world interest rates.[3]

The recent financial crisis underlined another lesson: that people do not have good models of the fundamentals. Bankers did not have a model telling them that if all the banks have bought credit default insurance, the value to them of such insurance was endangered; and that if they were all acquiring mountainous levels of mortgages, the value of a mortgage was going to be reduced on that account. I would say that the actors did not have adequate economic knowledge, not that they were short of the required cognitive abilities.

2. The second question that came up in my work is where innovative ideas come from. Schumpeter in 1911 offered a facile answer: they come from outside the economy – from Queen Isabella or the Archbishop of Salzburg. Similarly, the standard neo-Schumpeterian models of the present age say that there is no new economic knowledge to be acquired. There are only explorations (such as drilling for oil) that turn up results according to a known probability distribution.

We know for a fact that in an economy driven by a well-functioning capitalist system, such as the U.S. economy, most

[3] Suppose that everyone the fundamentals according to which world real interest rates will remain low only for a time. If people nevertheless suspect that all or most *others* subscribe to a theory that interest rates *were* going to stay down forever. Then speculators, expecting that these others would force a higher price of houses in the future, would drive the present level of the price of housing to a level above where it would have been under rational expectations; and housing output would thus be pulled up farther. (As the price then fails to be rising as fast as expected and housing rent declines with the rising housing stock, speculators stop buying up the increased output off the market, output drops back and the price falls.)

ideas are born in the course of daily business in the economy. Through workaday imagination and experimentation, productivity is constantly growing even in decades when there have been no breakthroughs exogenous to the industry or the economy.

The neo-Schumpeterian mindset is also costly. It pins hopes for a better economy on increased budgets for national scientific research agencies. After confusing technology with science, it confuses productivity with technology. (Richard Nelson and Amar Bhide are devastating on the fetishism of the neo-techno-nationalist approach.) Besides leading nations down the garden path it also detours them from the right path. In ignoring evidence that a nation's economic culture has a huge influence on the level of its productivity and, more important, the experience of creativity, imagination, and adventure, it encourages the assumption that the economic culture is not important for a successful economy.

It has been necessary, therefore, to reconstruct our image of the innovation process. Hayek began the modern formulation by introducing the Hayekian innovator who does not know whether the new book or new product line under consideration will catch on or flop. It has only been necessary for us to add the modern financier, who must largely *guess* the value of a new entrepreneurial proposal and the modern pioneering end-user, who must rely on hunch in deciding whether it would repay the cost to take a chance on the new product.

3. The third question is what do human beings want in their life? In the early 2000s I started wondering whether how to justify a well-

functioning capitalism in view of the ability of continental western Europe, demonstrated several times, to catch-up with the economic leader, generally the U.S. I soon realized that the entire body of economics sees all work as a negative and sees the only positive in life to be consumption – and leisure, which is having a revival. If that is all there is to life, I would not be able to find a convincing justification for the modern economy and its dynamism.

This view of life is really very poisonous. I can’t imagine a better way to destroy the present young generation than to say to them that you can forget about industry, dedication, ambition, career because there is no point. There are no possibilities for exploration, adventure, creativity and imagination. And if perchance there are some possibilities, never mind because they are not valuable. Only the neoclassical goods are.

It has been hugely encouraging to see my recent writings extolling the classic conception of the Good Life – from Aristotle to Nietzsche, James and Bergson – received better than in my wildest imagination. So economics is changing in this way too. RE is out, innovation is in and so is not But it is all taking much too long. It will be great if the various voices for a revival of modernism can finally prevail against the voices for a suffocating, stultifying and sterile neoclassicism.