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A fruitless clash of economic opposites

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Published: November 2 2009 20:55 | Last updated: November 2 2009 20:55

In the theory wars, which are as much wars over policy choices, two very bad kinds of theories are driving out good theories.

Keynesian economics, which had been nearly forgotten inside the macro field, has found new voices from outside. They take the position that fiscal "stimulus" of all kinds is effective against slumps of all causes. Their strategy is to defeat their only popular rivals, the neoclassicals, by deriding their view that the employment downturn involves a contraction of the labour supply.

Neoclassical equilibrium theory, which some macroeconomists had grown sceptical of, has also found new practitioners. They take the position that, aside from bad policy moves, recessions, even "great" ones, are caused by random market events and corrected by market adjustments. Demand stimulus is of no use, since there is no systematic shortage of demand.

These spokesmen show little knowledge of the several theoretical perspectives in macroeconomics over the past 100 years. The "Keynesians" seem not to have studied Keynes and the neoclassicals misread or do not read Hayek. No wonder fallacies abound.

The fallacy of the "Keynesians" is their premise that all slumps, all of the time, are entirely the result of "co-ordination problems" – mis-expectations causing a deficiency of demand. Having modelled the effects of expectations decades ago, I know they have consequences. I agree that companies appeared to underestimate the cutbacks and price cuts of competitors on the way down. That excessive optimism signalled deficient demand for goods and labour. So any stimulus then may have had a Keynesian effect. By now, though, such optimism has surely been wrung out of the system. To pump up consumer or government demand would force interest rates up and asset prices down, possibly by enough to destroy more jobs than are created.

The fallacy of the neoclassicals is their tenet that total employment, though hit by shocks, can be said always to be heading back to some normal level. In this view, employment is impervious to shifts in any particular demand. If told that consumers are broke, they say that markets will respond by lowering interest rates until investment has filled the gap. If told that business investment looks weak and will not be getting the help of another housing boom, they say that a real exchange rate depreciation will fill the gap with an increase of net exports. They do not understand that interest rates cannot fall much in an open economy and that a weaker currency has contractionary effects on output supply that could spoil the expansion coming from the effects on export and import demands.

These fallacies lull analysts into the false sense that, one way or another, **a full recovery lies ahead** – thanks to government spending or to self-correcting market forces. As I see it, the poor state of balance sheets in households, banks and many companies augurs a "structural slump" of long duration. Employment will recover, quickly or slowly, only as far as investment demand will carry it. It is highly uncertain whether government spending on infrastructure would help, after taking into account the employment effects of the higher tax rates to pay for it.

The most profound fallacy is the newfangled idea that misalignment of incentives in banks caused the housing bubble – a bubble that, when it burst, shook the economy to its foundations. All can agree that increased lending and building ran into the awkward fact that costs increase when production is stepped up. On that account, prices sought a higher level. But that analysis does not capture the steep four-year climb in housing prices, which rose by more than 60 per cent.

To account for so large an increase, we have to recognise that expectations played a role. Speculators appear to have expected that housing prices would go sky-high, so prices took off and then went on climbing in anticipation that those high prices were getting closer. The banks, seeing the houses offered as collateral were worth more and more, responded by supplying an increasing flow of mortgage loans.

From this viewpoint, speculation drove the crisis. Misaligned incentives were not sufficient to do it – and not necessary either. Bubbles long predate bonuses. The crisis could have happened with a 1950s financial sector. The lesson the crisis teaches, though it is not yet grasped, is that there is no magic in the market: the expectations underlying asset prices cannot be "rational" relative to some known and agreed model since there is no such model.

The gravest error of the phony debate between two non-starters is that their superficial and mechanical character – the clockwork of the neoclassical system and the hydraulics of the Keynesian one – operate to distract policymakers from asking basic questions about the dynamism of the US and UK economies. Economics has paid a terrible price for its dalliances with the Keynesian and neoclassical theories. Now policymakers are being misled by the siren call of these same, hopelessly inadequate views.

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