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Essays

THE FINANCIAL CRISIS AND THE SYSTEMIC FAILURE OF THE ECONOMICS PROFESSION

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ABSTRACT

Economists not only failed to anticipate the financial crisis; they may have contributed to it—with risk and derivatives models that, through spurious precision and untested theoretical assumptions, encouraged policy makers and market participants to see more stability and risk sharing than was actually present. Moreover, once the crisis occurred, it was met with incomprehension by most economists because of models that, on the one hand, downplay the possibility that economic actors may exhibit highly interactive behavior; and, on the other, assume that any homogeneity will involve economic actors sharing the economist's own putatively correct model of the economy, so that error can stem only from an exogenous shock. The financial crisis presents both

an ethical and an intellectual challenge to economics, and an opportunity to reform its study by grounding it more solidly in reality.

Notes

1. Carmen Reinhart and Kenneth Rogoff (2008) argue that the current financial crisis differs little from a long chain of similar crises in developed and developing countries. We certainly share their view. The problem is that the received body of models in macro finance, to which these authors have prominently contributed, provides no room whatsoever for such recurrent boom and bust cycles. The literature has, therefore, been a major source of the illusory "this time it is different" view that the authors themselves criticize.

2. Indeed, few researchers explored the consequences of a breakdown of their assumptions, even though this was rather likely.

3. The historical emergence of the representative-agent paradigm is a mystery. Ironically, it appeared during the 1970s, after a period of intense discussion of the problem of aggregation in economics (which basically yielded negative results). The representative agent, however, appeared without similar methodological discussion. In the words of Deirdre McCloskey, "It became a rule in the conversation of some economists because Tom and Bob said so" (personal communication). Today, this convention has become so strong that many young economists wouldn't know of an alternative way to approach macroeconomic issues.

4. The reductionist conceptual approach of the representative agent is also remarkably different from the narrative of the "invisible hand," which also has the flavor of "more is different."

5. It is pretty obvious how the currently popular class of dynamic general-equilibrium models would have to "cope" with the financial crisis. It would be covered either by a dummy variable or interpreted as a very large negative stochastic shock to the economy, i.e., as an event equivalent to a large asteroid strike.

6. Robert Solow (2008, 235) has called it a "rhetorical swindle" that the "macro community has perpetrated on itself, and its students."