

The End of the Consensus in Macroeconomic Theory “or There and Back Again”¹



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1. With apologies to J.R.R. Tolkien



Is there Progress in Macroeconomics?

- From the time of Keynesian revolution there have been periods of divisive debates, with brief periods of agreement (e.g., the neoclassical synthesis of Samuelson in the 1960s).
- The vitriolic debates in the 1980s over monetarism, New Classical economics versus the new-Keynesian economics - *the Macroconfusions* (Nordhaus, 1983, Solow, 1993).
- But remarkably in the 1990s came the *New Neoclassical Synthesis* (with a nod to Samuelson) otherwise known as the *New Consensus in Macroeconomics*.

The New Classical Macroeconomics (Goodfriend and King, 1997)



- *Core or benchmark model:*
- Rational expectations,
- real business cycles of the New Classical economics (benchmark model).

But:

- Also mark-up pricing, imperfect competition, market imperfections of the new-Keynesian economics, price rigidities (menu costs, efficiency wages, search unemployment)
- Hence a “consensus”; both “schools of thought” assumed they were (partial) winners in the bitter controversies of the late 1970s early 1980 (Mankiw, 2006)



New Classical Synthesis

- Theoretical rationale (*inter alia*) for *inflation targeting*.
- See Marvin Goodfriend (2004) “Monetary Policy in the New Neoclassical Synthesis: A Primer” (section 5).
- “The State of Macro is Good”, Blanchard (2008)

But the “Economics of Keynes” is Irrelevant



- *General Theory* took economics up a blind alley for half a century (Lucas).
- Instability of the economy over-emphasised and advocacy of *fiscal policy* wrong (Ricardian equivalence theorem).
- *General Theory* just a special case of the classical theory, based on **nominal and real rigidity**. Empirically not important, but in any case it is all in Pigou's *Theory of Unemployment* (1933)

But it all ended in tears..... Here's what two former members of the UK Monetary Policy Committee had to say two years later (2009)



[1] “As a monetary policy maker I have found the ‘cutting edge’ of current macroeconomic research *totally inadequate* in helping to resolve the problems we currently face. (Danny Blanchflower, 2009)

[2] “The typical graduate macroeconomics and monetary economics training received at Anglo-American universities during the past 30 years or so, may have set back by decades serious investigations of aggregate economic behaviour and economic policy-relevant understanding. (Willem Buiter, 2009)



A Return to Keynes?

Theoretical debate: 2007- present: Not about differences at the *frontier of the subject but about the very foundations.*

The Krugman *New York Times* & rejoinder by Cochrane

Brad DeLong's Blog: “The scary thing is not that Levine, Cochrane, Lucas, Prescott, Fama, Zingales and Bodrin [all New Classical Economists] are wrong – people are wrong all the time. The scary thing is the level at which they are wrong: *These are all freshman (ok, sophomore mistakes)* – yet the seven include two past and a year ago I would have said three future Nobel laureates in Economics.”

A rediscovery of Keynes and Minsky..... e.g. R.A. Posner, Mankiw, Krugman.

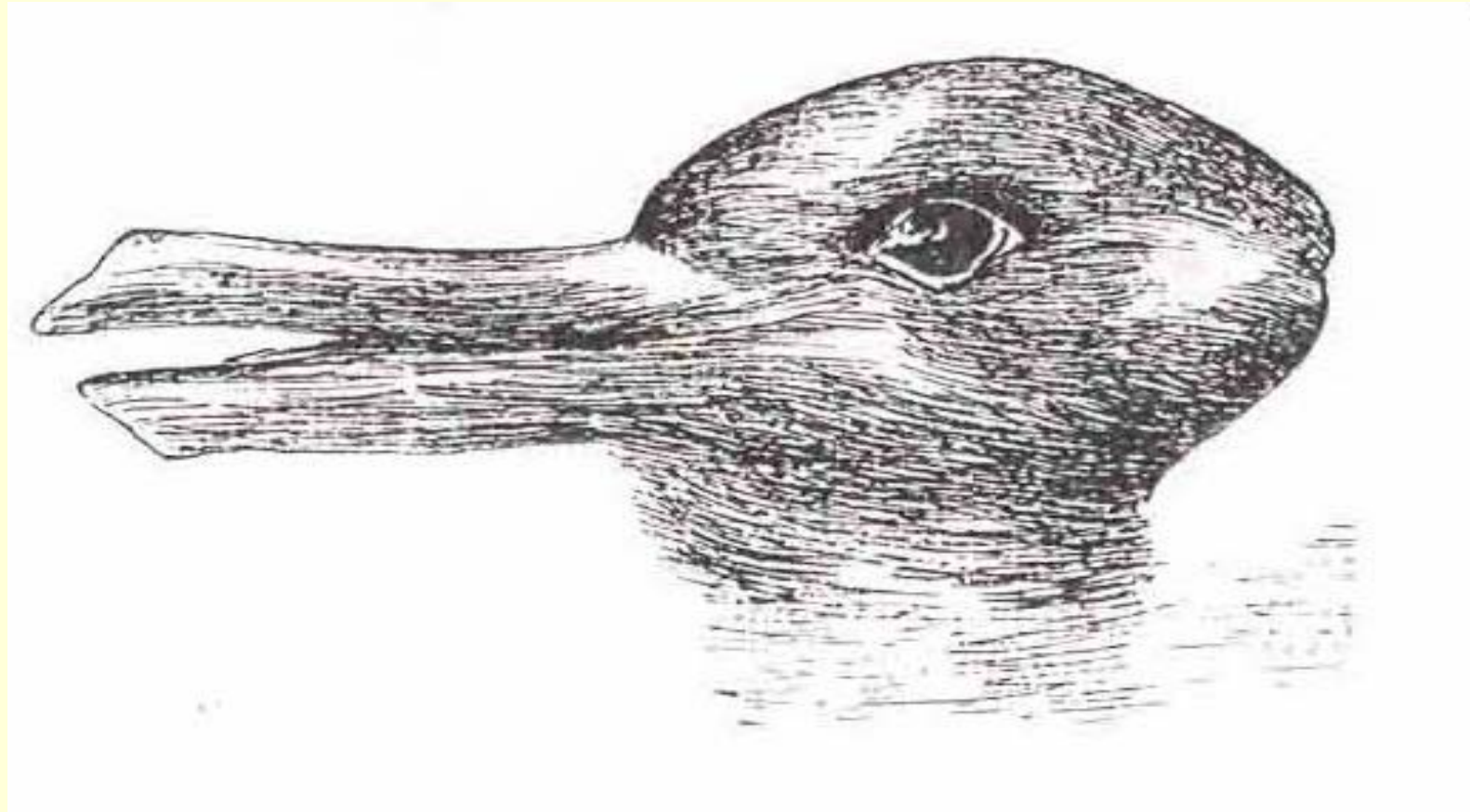
A Little Bit of Methodology: Kuhn



Why should we pay any attention to the philosophers of science? Kuhn's *Structure of Scientific Revolutions*

- The concept of the paradigm or “disciplinary matrix” Sets the puzzles that are worth solving
- The role of the scientific community.
- The “scientific revolution” as anomalies accumulate
- No *objective* method of comparing different paradigms; loss of content and incommensurability.

A Gestalt Switch



Economic Paradigms



Classical economics



Hydraulic Keynesian Economics ▶ **IS/LM Keynesian Economic** ▶ **Post Keynesian Economics** ▶ ??



AS/AD model; The Neoclassical Synthesis ▶ **Neo-Keynesian Economics** ▶ ??



Monetarism



New Classical Economics (Efficient Markets Hypothesis)



The New Neoclassical Synthesis ▶ ??

Economic Paradigms (Cont.)



I Strong Incommensurable Paradigms

Marxian Economics (Social class, an emergent property, no “meaning” in neoclassical microeconomics)

Neoclassical microeconomics (Utility, methodological individualism, no “meaning” in Marxian economics)

II Weak Incommensurable Paradigms

Economics of Keynes

New Classical Economics

(*Paradigmatic assumptions* incompatible, but there are shared theoretical concepts)

Why do “Scientific” Revolutions Occur in Economics?



Not the result of predictive failure

- *Not* as the result of econometric results: Larry Summers “*The Scientific Illusion in Empirical Macroeconomics*”, (1991)
- Name one econometric result that has changed anyone’s view of the way the economy works.
- *Calibration* versus *econometrics*.

“Reswitching” of Economic Paradigms



Why is that earlier economic paradigms make a come back, albeit it in a more sophisticated form?

According to Kuhn, this does *not* occur in the physical sciences, because of incommensurability.

Kuhn’s criteria of “accuracy of prediction” is not relevant for economics.

Paradigmatic pseudo-assumptions



- These are hybrid *analytic-synthetic* sentences.
- *Analytic* because not testable by fiat; *synthetic* because they are not the result of arbitrary definitions. In the natural sciences subject to extensive testing.
- The pseudo-assumptions of the Keynesian and New Classical paradigms. Thus, paradigmatic debates involve these and they are *weakly incommensurable*.

So how do we choose between paradigms? The Role of Rhetoric



- Debates over the *paradigmatic pseudo-assumptions*
(See Alan Blinder, “Keynes, Lucas and Scientific Progress”)
- The use of persuasion and rhetoric (McCloskey).

Appeal to authority, *argumentum ad hominem*, metaphors, taste, aesthetics, power relations within the profession.

But limitations: The “free market” for ideas is always right (McCloskey)

- But there is no *objective* criteria by which to choose between paradigms. Bound to be inconclusive.

Why did The Keynesian Revolution Unravel?



Paradigmatic Pseudo-assumptions

(i) *Aggregate economic relations* and interactions of agents (“fallacy of composition”)

(ii) *Uncertainty* (as opposed to risk) Cornerstone of his *QJE* (1937) also “Chapter 12 General Theory”,

Treatise on Probability (1921)

- (a) Risk or cardinal probability
- (b) Ordinal probability
- (c) Irreducible uncertainty “Animal Spirits”

“Conventional” expectations: Leads to self fulfilling prophecies and *herd behaviour*. *Non-ergodic* (Davidson 1982)..

The Disappearance of “Uncertainty” from the Economics Keynes



Hicks' IS/LM simple general equilibrium model became
“Keynesian economics”

Historic time disappeared; comparative statics, stable
relationships, *no mention of uncertainty*.

Did Keynes approve? “Nothing to say by way of criticism”

Hicks recants (“IS-LM an Explanation”, *JPKE* , 1980-81,
Shackle, *JPKE*,1982)

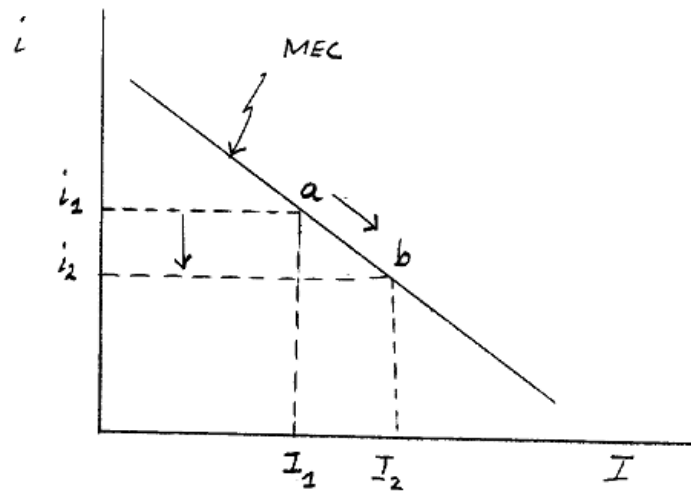
Rescuing Uncertainty and Investment



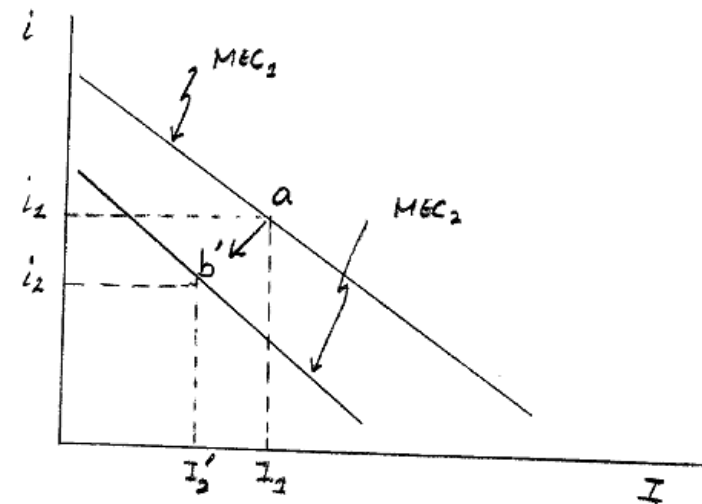
The Investment Function in the Face of Uncertainty

Investment = f (expected output and the rate of interest)

(a)



(b)



The Shortcomings of Chapter 2 of the *General Theory*

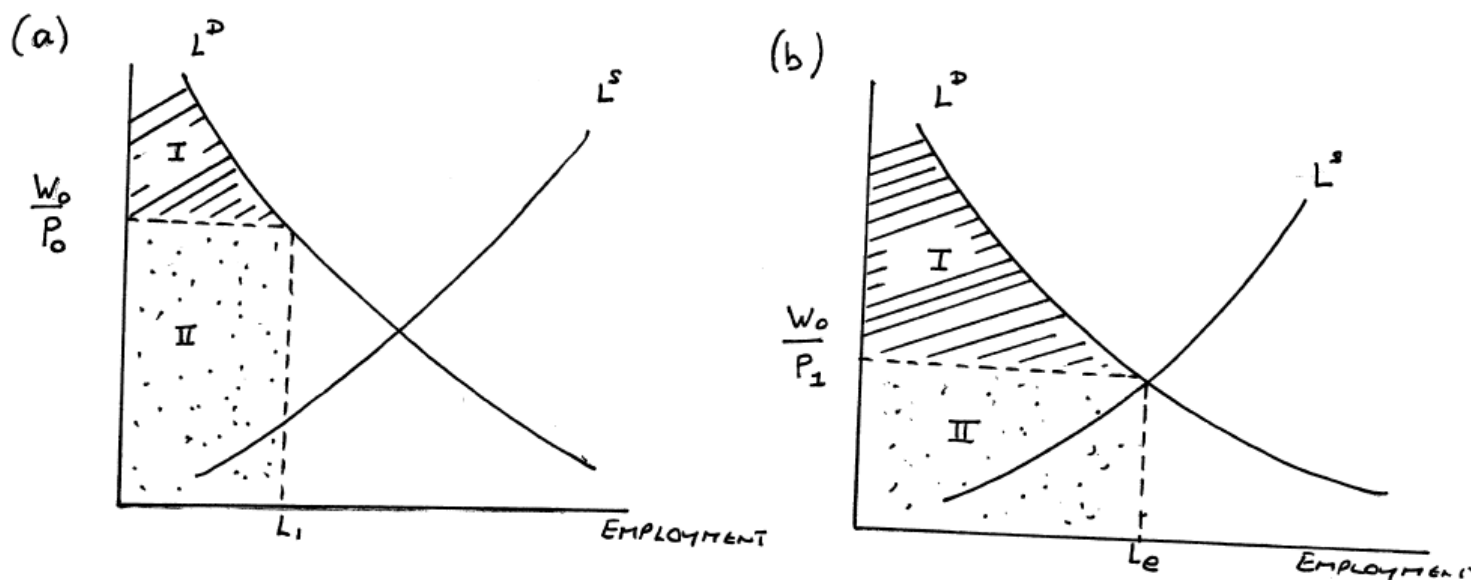


- Keynes: Chapter 2 of *GT* Asserted that Unemployment **not** due to real wages being too high.
- “The fact is I think that Keynes wanted to get labor markets out of the way in chapter 2, so he could get on to the demand theory which really interested him” (Lucas, 1978 p. 354.)



Why a Fall in the Real Wage *Must* Create Demand Why Unemployment *must* be due to Real Wage Rigidity

The Aggregate Demand for, and Supply of, Labour

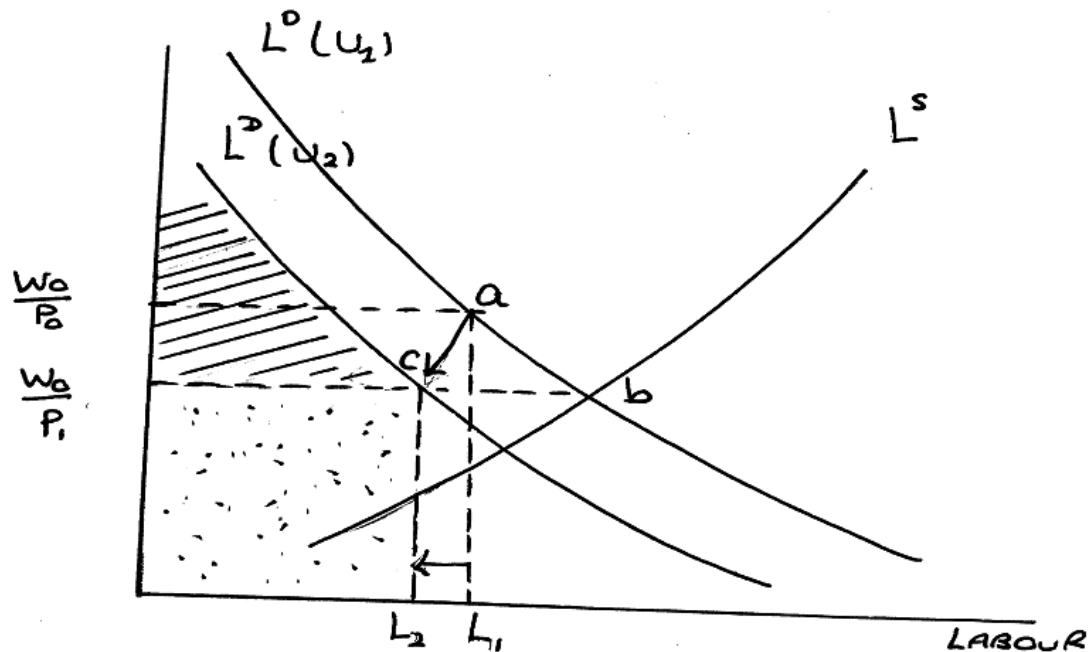


I: PROFITS \equiv INVESTMENT
II: WAGES \equiv CONSUMPTION.



But *not* When there is a Change in Capacity Utilisation

**The Aggregate Demand for, and Supply of, Labour
Changes in Capacity Utilization**



The Neoclassical Assessment of Keynes



(i) Merely a special case of the Classical school of thought because of *ad hoc* assumption of wage rigidity.

(ii) The only role for effective demand is to drive the price level up and the real wage down.

The neoclassical economists argued that there was a need more plausible **paradigmatic pseudo-assumptions**.



Paradigmatic Pseudo-assumptions

Neoclassical Economics/New Classical Economics

(i) Need for *micro foundations*

Modelled by *representative agent/firm*. Methodological reductionism.

(ii) Need for formal and rigorous “toy” models (i.e., mathematical models).

(iii) Need to explain economic phenomena as far as possible in terms of agents *optimising subject to constraints*. “Actors” utility maximise or firms profit maximise.

(iv) Forward looking *rational (“model-consistent”) expectations*

(v) Markets clear – consequent of (iii) (there are no unexploited trades, these would be irrational). Only violate this assumption by introducing some form of market rigidities but these are likely to be unimportant (New Classical) or important (Neo-Keynesianism.)

(iv) Non-clearing markets due to shocks of some sort (probably real) – a *disequilibrium* phenomenon, but markets are self-stabilising.

Paradigmatic Pseudo-assumptions Implications



Paradigmatic determinism

(i) There cannot be any *involuntary unemployment*. Term is meaningless
(Lucas R.E. (1987) *Unemployment Policy*)

Employment variations a result of intertemporal substitution of work in the face of expected differences in productivity.

(ii) *Some allowance for rigidities* (search models, menu costs)

but all are the result of optimising procedures

(iii) Fluctuations are optimal (real business cycle)

(iv) *The degree of excess capacity*: optimal

Paradigmatic Assumptions: Representative Agent/ Optimising Models



- Intra-Paradigmatic Criticisms
 - **Alan Kirman (1988, 1992)** (Sonnenschein-Debreu- Mantel. Exchange economy cannot generate uniqueness equilibrium and stability as microfoundations)
 - **Frank Fisher (1969, passim)** Aggregate production functions do not exist even as an approximation. The fact that they can give good statistical fits is irrelevant (Jesus Felipe and John McCombie)
 - The representative agent is not a useful simplification, it is essential for *avoiding* (not solving) aggregation problems.

Paradigmatic Assumptions: Representative Agent/ Optimising Models



- **Inter-Paradigmatic Criticisms**

- ✓ No coordination problems, no problem in transmitting effective demand; (no Clower dual-decision hypothesis).
- ✓ In effect, a barter economy. *By construct* no involuntary unemployment. No banks, no need for liquidity.
- ✓ Who is the representative agent?; school-leaver with no GSEs, the CEO of a major bank (Solow). *Devoid of any institutional context.*
- ✓ Does *anybody* alter hours worked because their productivity (wage) may differ between periods. Again the institutional context.
- ✓ Behaviour by introspection, not empirical analysis.

Paradigmatic Assumptions: Rational Expectations Hypothesis



- The failure of the ergodic hypothesis (**Paul Davidson**)
- Is there one objectively correct model of the economy?
- The difference between Knightian “risk” and “uncertainty”

“The sense in which I am using the term [uncertainty] is that in which the prospect of a European war is uncertain, or the price of copper or the rate of interest twenty years hence, or the obsolescence of a new invention, or the position of private wealth owners in the social system in 1970.”

(Keynes, 1937)



The Sub-prime Crisis

- New Classical Economics has zero impact on monetary policy (Mayer)
- Consequences of the Rational Expectations and the Efficient Market Hypothesis
- Been there before:
Long-Term Capital Management. (1994-1998) Meriwether, Merton, Scholes.
- “Market-neutral arbitrage” Sophisticated computer models to calculate volatility (\equiv risk). Precise predictions of possible losses. High leverage e.g., 30:1, based on convergence in the rates of return of Treasury bills.

Those who Ignore history.....



- 1998 Russian default; widening of international bonds; huge losses as herding occurred. Fed had to step in to rescue LTCM, fear of a complete financial crash
- Problem of the “Fat tails” , warnings by Fama. After the crash, Larry Summers “The efficient markets hypothesis is the most remarkable error” (ten years ago!)
- Yet..... then came the subprime crisis.

Conclusions



What have we learnt?

And to finish

