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

John McCombie
Director
Centre for Economic and Public Policy
University of Cambridge

and

Maureen Pike
Associate Member
Centre for Economic and Public Policy
& Oxford Brookes University

¹. With apologies to J.R.R. Tolkien
Is there Progress in Macroeconomics?

- From the time of Keynesian revolution there have periods of divisive debates, with brief periods of agreement (e.g., the neoclassical synthesis of Samuelson in the 1960s).


- 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.


• “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 (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 of 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”

Rescuing Uncertainty and Investment

The Investment Function in the Face of Uncertainty

Investment = f(expected output and the rate of interest)
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 = Investment
II: Wages = 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
  
  
  – 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 GSCEs, 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:

• “Market-neutral arbitrage” Sophisticated computer models to calculated volatility (≡ risk). Precise predictions of possible loses. 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 loses as herding occurred. Fed had to step in to rescue LCTM, 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