

Economics focus

In defence of the dismal science

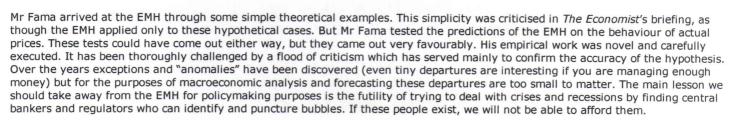
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In a guest article, Robert Lucas, the John Dewey Distinguished Service Professor of Economics at the University of Chicago, rebuts criticisms that the financial crisis represents a failure of economics

THERE is widespread disappointment with economists now because we did not forecast or prevent the financial crisis of 2008. *The Economist's* articles of July 18th on the state of economics were an interesting attempt to take stock of two fields, <u>macroeconomics</u> and <u>financial economics</u>, but both pieces were dominated by the views of people who have seized on the crisis as an opportunity to restate criticisms they had voiced long before 2008. Macroeconomists in particular were caricatured as a lost generation educated in the use of valueless, even harmful, mathematical models, an education that made them incapable of conducting sensible economic policy. I think this caricature is nonsense and of no value in thinking about the larger questions: What can the public reasonably expect of specialists in these areas, and how well has it been served by them in the current crisis?

One thing we are not going to have, now or ever, is a set of models that forecasts sudden falls in the value of financial assets, like the declines that followed the failure of Lehman Brothers in September. This is nothing new. It has been known for more than 40 years and is one of the main implications of Eugene Fama's "efficient-market hypothesis" (EMH), which states that the price of a financial asset reflects all relevant, generally available information. If an economist had a formula that could reliably forecast crises a week in advance, say, then that formula would become part of generally available information and prices would fall a week earlier. (The term "efficient" as used here means that individuals use information in their own private interest. It has nothing to do with socially desirable prices.

individuals use information in their own private interest. It has nothing to do with socially desirable pricing; people often confuse the two.)



The Economist's briefing also cited as an example of macroeconomic failure the "reassuring" simulations that Frederic Mishkin, then a governor of the Federal Reserve, presented in the summer of 2007. The charge is that the Fed's FRB/US forecasting model failed to predict the events of September 2008. Yet the simulations were not presented as assurance that no crisis would occur, but as a forecast of what could be expected conditional on a crisis not occurring. Until the Lehman failure the recession was pretty typical of the modest downturns of the post-war period. There was a recession under way, led by the decline in housing construction. Mr Mishkin's forecast was a reasonable estimate of what would have followed if the housing decline had continued to be the only or the main factor involved in the economic downturn. After the Lehman bankruptcy, too, models very like the one Mr Mishkin had used, combined with new information, gave what turned out to be very accurate estimates of the private-spending reductions that ensued over the next two quarters. When Ben Bernanke, the chairman of the Fed, warned Hank Paulson, the then treasury secretary, of the economic danger facing America immediately after Lehman's failure, he knew what he was talking about.

Mr Mishkin recognised the potential for a financial crisis in 2007, of course. Mr Bernanke certainly did as well. But recommending pre-emptive monetary policies on the scale of the policies that were applied later on would have been like turning abruptly off the road because of the potential for someone suddenly to swerve head-on into your lane. The best and only realistic thing you can do in this context is to keep your eyes open and hope for the best.

After Lehman collapsed and the potential for crisis had become a reality, the situation was completely altered. The interest on Treasury bills was close to zero, and those who viewed interest-rate reductions as the only stimulus available to the Fed thought that monetary policy was now exhausted. But Mr Bernanke immediately switched gears, began pumping cash into the banking system, and convinced the Treasury to do the same. Commercial-bank reserves grew from \$50 billion at the time of the Lehman failure to something like \$800 billion by the end of the year. The injection of Troubled Asset Relief Programme funds added more money to the financial system.

There is understandable controversy about many aspects of these actions but they had the great advantages of speed and reversibility. My own view, as expressed elsewhere, is that these policies were central to relieving a fear-driven rush to liquidity and so alleviating (if only partially) the perceived need for consumers and businesses to reduce spending. The recession is now under control and no

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responsible forecasters see anything remotely like the 1929-33 contraction in America on the horizon. This outcome did not have to happen, but it did.

Not bad for a Dark Age

Both Mr Bernanke and Mr Mishkin are in the mainstream of what one critic cited in *The Economist's* briefing calls a "Dark Age of macroeconomics". They are exponents and creative builders of dynamic models and have taught these "spectacularly useless" tools, directly and through textbooks that have become industry standards, to generations of students. Over the past two years they (and many other accomplished macroeconomists) have been centrally involved in responding to the most difficult American economic crisis since the 1930s. They have forecasted what can be forecast and formulated contingency plans ready for use when unforeseeable shocks occurred. They and their colleagues have drawn on recently developed theoretical models when they judged them to have something to contribute. They have drawn on the ideas and research of Keynes from the 1930s, of Friedman and Schwartz in the 1960s, and of many others. I simply see no connection between the reality of the macroeconomics that these people represent and the caricature provided by the critics whose views dominated *The Economist's* briefing.

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