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The Economists Who Didn't Cry Wolf



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The *Financial Times* last week ran a blog series titled, "what's the point of economists?" As an economist, I thought it was a good question.

The discipline has not covered itself in glory in recent years, or so it can be argued, with persuasive empirical support in the millions of jobs lost, and the businesses ruined, and the trillions in wealth evaporated at market values. After a calamity such as the current one, it is natural, indeed useful, to seek to understand what happened, and to assign blame – and bankers have nearly worn out their utility as punching bags. Enter economists.

"Economists didn't warn us that the bottom might fall out!" That kicks off the learned debate. "Some did issue warnings," say some. "Did not," say others. "Did too...didn't", etc; not particularly helpful. There has followed some jawing about whether economics is a science or not, and whether academic abstractions have relevance to what might be useful in practice, and whether ideology ("justification research") corrupts objectivity.

The truth of the matter, as I see it, is that many economists warned of risk exposures inherent in the great imbalance of global trade and investment. Quite a few suggested that disruptions, if they were to occur, might be momentous in scale. A very few became strident at about the right time (Roubini, Shiller). None, however, was able to make the case in a specific and timely enough manner to – here's the rub – affect either the behaviors of the general public or the policies of those in position to do something to avert the sorry result.

Mamas, don't let your babies grow up to be prognosticators. They are almost surely doomed to get the big things wrong, even if they manage to get the little ones right. Suffice it to say that ignorance, or pure Knightian uncertainty if you prefer, has been an inescapable fact of human existence ever since our kind was cast out of the garden, whether literally or metaphorically.

Perhaps someone should coin a Law of Conservation of Risk. Maybe, as with matter and energy, it can be neither created nor destroyed. What might go wrong – what risks do you face – if, for example, your savings are heavily invested in common stocks?

One, the economy might go into recession, with adverse effect on corporate earnings. Two, inflation might soar, undercutting the real value of at least some of your holdings. Three, government policies might turn hostile to your interests.

In the late 1990s, however, all of these risk factors, and others, seemed benign: the U.S. economy was booming and jobs were going begging, disinflation was progressive, federal budget deficits disappeared, the Fed was friendly and the dollar was strong. The market had nothing to fear – so it created its own risk factor: valuations that pushed beyond previous extremes.

When there is nothing to fear, be very afraid. The current housing-centered calamity differs only slightly from that of the tech stock meltdown: different asset class, similar market dynamics, same result.

Recall that macroeconomics is the fancy word for what previously was called political economy. (Just the use of the term political should close the conversation on whether macro is a science or not.) Since it is all about people in their daily lives going about the activities of getting and spending, then unless the economist who studies this activity is non-human – i.e. not one of the people – it will be subject to a distorting observer effect. This effect states that the act of observation affects the phenomenon being observed: the observer is part of the experiment. Said in a different way, people far exceed the capabilities of lab rats in figuring out how to game the system and find the cheese.

So, a question: if you were to solve once and for all the inexplicabilities of macroeconomics, what would you do first – publish the paper, or place your trades? Follow-up question: do you think others would answer as you just did?

Can't live with 'em, can't live without 'em

No one has yet solved all the riddles of human behavior but some progress has been made. The field of economics has been broadened and deepened since Adam Smith's day. In 50 or 100 years, will the discipline be capable of preventing the sort of catastrophe that we are dealing with now? I'll admit that I doubt it. After all, we are at least that far past the late 19th century and the panics that

characterized those *laissez-faire* times. We've learned how to cope better with the aftermath of such meltdowns, and we have conceived institutions – the Fed, FDIC, and many others – that have cushioned, or minimized, or even in some cases prevented, these occurrences. But in the same way that "solving" the problems of economic growth and inflation in the late 1990s led to a ballooning of risk in a different form, the management of smaller cycles may lead to an accumulation of stresses that finally precipitates a big cycle, as seems to have been the case in this instance. It wasn't much more than two years ago, after all, that we could congratulate ourselves for the flexibility and soundness of our financial system. There was nothing to fear in that quarter, was there?

Health care reform is hot today. I'm struck most by the quite plausible projections of "national bankruptcy" if we don't get it right, or at least get it better. These forecasts are issued by credible organizations such as the Congressional Budget Office and the Office of Management and Budget. The debate today seems to me to be much more about the details (and yes, of course that's where the devil is) than it is about the big picture. But you'd think that, standing in the hole we now occupy, we'd be more attuned to warnings of really big problems down the road than it seems to me we are.

How did that fable turn out? Wasn't the boy who cried wolf eventually eaten by wolves? ■

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