How should the collapse of the world financial system affect economics?

Part I

After 1929 economics changed: Will economists wake up in 2009?

Geoffrey M. Hodgson [University of Hertfordshire, UK]

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We are all Keynesians again

A remarkable feature of the unprecedented financial crisis that erupted in September 2008 is the doctrinal shift among world leaders. The market is no longer seen as the solution to every problem. The state has to step in to save capitalism. The US Republican Party had been the champion of free markets and minimal state intervention, yet President George W. Bush became the exponent of a huge state bale-out of the banks with a massive extension of state ownership within the financial system.

Alan Greenspan, former chairman of the US Federal Reserve, belatedly declared that he had 'made a mistake in presuming that the self-interest of organizations, specifically banks' would protect 'shareholders and equity in the firms'. He had 'discovered a flaw in the model' of liberalisation and self-regulation (*Guardian*, 24 October 2008).

All UK Prime Ministers since Margaret Thatcher have promoted market liberalisation. Yet everything changed with the global financial crisis. Prime Minister Gordon Brown's package of measures including partial state ownership of banks became the global model. On 19 October 2008 the Chancellor of the Exchequer Alistair Darling announced massive government spending to kick-start the British economy. He said that the economic thinking of John Maynard Keynes was coming back into vogue.

Who were the prophets of the financial mayhem of 2008? On 7 September 2006, Nouriel Roubini, an economics professor at New York University told International Monetary Fund economists that the US was facing a collapse in housing prices, sharply declining consumer confidence and a recession. Homeowners would default on mortgages, the mortgage-backed securities market would unravel and the global financial system would seize up. These developments could destroy hedge funds, investment banks and other major financial institutions. Economist Anirvan Banerji responded that Roubini's predictions did not make use of mathematical models and dismissed his warnings as those of a habitual pessimist (New York Times, August 15, 2008).

In October 2008 the British sociologist Laurie Taylor asked listeners of his weekly BBC radio programme to find an economist who had predicted the 2008 credit crunch and financial crisis. The nominations were scrutinised carefully and most were rejected. On 15 October 2008 the radio host announced that the most prescient prophet of the outcome of international financial deregulation since 1980 was the relatively obscure British financial

economist Richard S. Dale. In his book on International Banking Deregulation, Dale (1992) had argued that the entry of banks into speculation on securities has precipitated the 1929 crash, and that growing involvement of banks in securities activities resulting from incremental deregulation since 1980 might precipitate another financial collapse. Dale's book received a mixed review in the Journal of Finance in 1993 and slipped off the citation rankings.

Hyman Minsky (1919-1996) got some credit too. In a series of papers, Minsky (1982, 1985, 1992) argued that capitalism has an inherent tendency to instability and crisis. The key destabilising mechanism is speculation upon growing debt. Minsky gave a number of warnings about the severe consequences of global financial deregulation after 1980. Although championed by Post Keynesians, Minsky's ideas were never popular with the mainstream. Yet on 4 February 2008 the New Yorker noted that references to Minsky's financial-instability hypothesis 'have become commonplace on financial Web sites and in the reports of Wall Street analysts. Minsky's hypothesis is well worth revisiting.'

But does anyone read Keynes?

Chancellors, bloggers, newspapers and magazines may have noticed the relevance of such economists as Keynes and Minsky for today, but have they been rediscovered in departments of economics in the most prestigious universities? I eagerly await any signs of such an awakening. In the meantime we may record the neglect into which even Keynes has fallen. I tried without success to find the work of Keynes or Minsky on any reading list available on the Web of any macroeconomics or compulsory economic theory course in any of the top universities in the world. Indeed, reading lists themselves are hard to find for any of the most prestigious courses in economics. Instead, there is ample evidence of student proficiency requirements in mathematics.

Turn to the most prestigious journals in economics. By searching leading journals that have been in existence since 1950, we can ascertain how many times the aforementioned authors were cited in each decade. Table 1 shows the results. Keynes remains the most highly cited of the four authors, but his visibility in leading journals has dropped dramatically in each decade. The overall picture in leading journals of economics is one of the dramatic fall in any the discussion of Keynes' ideas, and a relative neglect of other authors who warned of the dangers of financial deregulation.

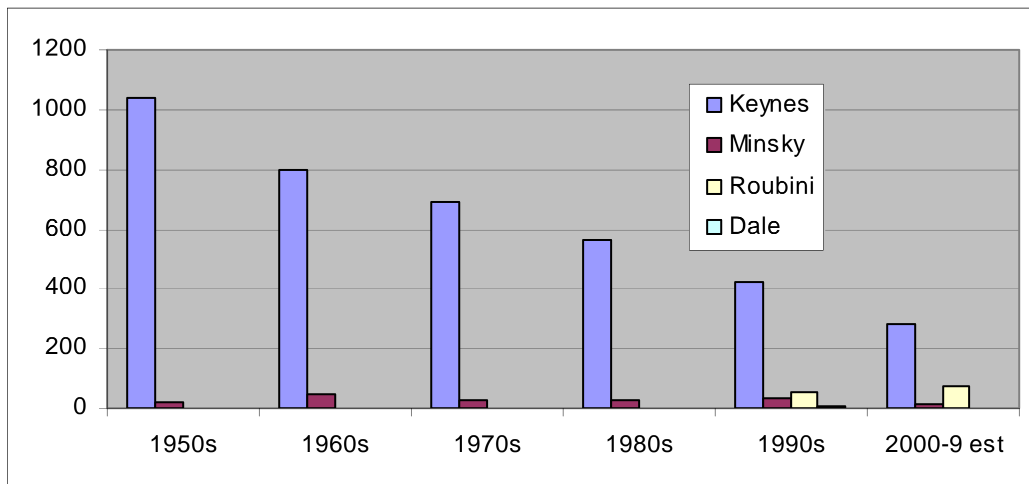

Table 1: Number of Articles or Reviews Citing Keynes, Minsky, Roubini and Dale in Leading Journals of Economics and Finance

Source: JSTOR. 2000-9 figures are estimated from extant results.

Journals used: American Economic Review, Econometrica, Economic Journal, Economica, Journal of Finance, Journal of Political Economy, Quarterly Journal of Economics, Review of Economic Studies, Review of Economics and Statistics.

The outsider may imagine that this is simply a matter of misjudgement or prejudice. Academic economists are simply citing the wrong people. Instead of citing Milton Friedman or Friedrich Hayek they should be referencing Keynes' General Theory. Such a perception of what has gone wrong would be mistaken. By citation measures, Keynes's classic antagonists do little better. Take Nobel Laureate Friedman: from 1950 he was cited by an average of only 344 articles or reviews per decade, in the same list of journals. Nobel Laureate Friedrich Hayek was cited by only 139 items per decade. Nobel Laureate Gerard Debreu, a mathematical economist and pioneer of general equilibrium theory, was cited by only 24 items per decade. Mainstream economists seem to have stopped citing anyone, except the most recent pioneers of mathematical technique.

Do economists learn?

As things stand, to get published in leading journals it is no longer necessary to read or cite any economist beyond the recent past. Instead of classic texts, most economists are interested in mathematical models. As Friedman (1999, p. 137) has complained: 'economics has become increasingly an arcane branch of mathematics rather than dealing with real economic problems.' A Commission of the American Economic Association on the state of graduate education in economics feared that 'graduate programs may be turning out a generation with too many idiot savants skilled in technique but innocent of real economic issues' (Krueger et al, 1991, pp. 1044–5). Other leading economists have expressed similar worries (Blaug 1997).

In the high temples of economics, mathematical technique now dominates real-world substance. Hence the tasks of reforming economics are very different from those that faced economists after the Great Crash of 1929. In both style and substance, economics was a very

different subject then. Keynes' argument was that the assumptions behind laisser faire economics were inappropriate for the real work economic system. By 1945, the experience of the Great Depression and subsequent recovery had convinced the majority of the profession that Keynes was right.

It was not primarily a battle of economic models or econometric techniques. But ironically, the Great Depression helped to provide an impetus for more extensive use of mathematics in economics. A younger generation of economists, impatient with the failure of the older economists to find solutions, turned to mathematical models. Reflecting on this earlier period of his life, before he turned to institutional economics and became a critic of the neoclassical mainstream, Gunnar Myrdal (1972, pp. 6-7) wrote:

> Faced with this great calamity, we economists of the 'theoretical' school, accustomed to reason in terms of simplified macro-models, felt we were on the top of the situation ... It was at this stage that economists in the stream of the Keynesian revolution adjusted their theoretical models to the needs of the time, which gave victory much more broadly to our 'theoretical' approach.

Other economists reached a similar verdict (Hodgson 2004, pp. 383-6). A group of young and mathematically minded converts to Keynesianism, led by Paul Samuelson and others, developed some simple macroeconomic models. The attraction of this approach was partly its technocratic lure, and partly because it proposed apparent solutions to the urgent problem of the day. It appeared that increasing a variable called G could alleviate the problem of unemployment. The 'solution' was plain and beguiling and dressed up in mathematical and 'scientific' garb. Although Keynes himself warned of the limitations of mathematical technique in economics (Moggridge, 1992, pp. 621-3), he was championed by people who saw mathematics as the solution.

Although the Great Depression changed our discipline by establishing Keynesian macroeconomics, it also gave impetus to the process of mathematical formalization that took off in the post-war period. Although Keynes fell out of vogue from the 1970s to 2008, and the character of mainstream economics has changed in other respects in recent decades, its obsession with technique remains. The pressing question now is whether the financial crisis 2008, which is the most severe since the Great Depression, will reverse this fascination with mathematical technique over real-world substance.

We may remind ourselves of an incident eleven years before the 2008 credit crunch. In 1997 Robert C. Merton and Myron S. Scholes were awarded the Nobel Prize in Economics. Scholes had helped to devise the Black-Scholes equation, upon which a prominent hedge fund was based. However, following the 1997 financial crisis in Russia and East Asia, the highly leveraged fund lost in 1998 $4.6 billion in less than four months and failed. (http://en.wikipedia.org/wiki/Myron_Scholes, accessed 20 October 2008.) Did the myopic modellers wake up then? Alas no.

Do not adjust your model – reality is at fault?

Neither crashes, crises nor failures of prediction necessarily impel economists in the direction of realism. One likely reaction to the current downturn is that we should try harder to develop better models. Perhaps we should, but we must also learn the vital lesson that models on their own are never enough. A better understanding of our current predicament

must also come from a much fuller appreciation of both economic history and the history of ideas in economics. What is required is a wholesale revitalisation of the culture within the economics profession.

The June 2000 protest of French students is as relevant as before. They objected to the use of mathematics as 'an end in itself' and dogmatic teaching styles that leave no place for critical and reflective thought. They petitioned in favour of engagement with empirical and concrete economic realities, and for a plurality of theoretical approaches.

To understand the current economic crisis we have to look at both economic history and the history of economic thought. To understand how economics has taken a wrong turning we have to appreciate work in the philosophy of economics and the relationship between economics and ideology. These unfashionable discourses have to be brought back into the centre of the economic curricula and rehabilitated as vital areas of enquiry.

Unless mainstream economics takes heed of these warnings and proves its relevance for the understanding of the most severe crisis of the capitalist system since the 1930s, then it will be doomed to irrelevance. My suggestion is that a world protest of academic, student and business economists be organised to drive home this point. To avoid dismissal as yet another heterodox whinge, this protest has to be led by high-ranking economists that are concerned about the direction of our subject. I would like to put this issue at the top of our agenda.

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www.geoffrey-hodgson.info
g.m.hodgson@herts.ac.uk

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