Opinion

Wanted: grown-ups to rescue Britain's high street
Anne Ashworth, page 32

Economists are the forgotten guilty men

Academics – and their mad theories – are to blame for the financial crisis. They too deserve to be hauled into the dock

Anatole Kaletsky

In the search for the "guilty men" responsible for the near-collapse of the global economy, one obvious group of scapegoats has escaped blame: the economists.

By "economists" I do not mean the talking heads (myself included) employed by the media and financial institutions to "explain", usually after the event, why share prices or currencies have gone up or down. Nor do I mean the forecasters whose computers churn out scientific-looking numbers about what will happen to growth or inflation, but whose figures are revised so drastically whenever something "unexpected" happens — as it always does — that their forecasts are really nothing more than backward-looking descriptions of recent events.

What I mean by "economists" are the academic theorists who win Nobel prizes, or dream of winning them. To see why these seemingly obscure academics deserve to be hauled out of their ivory towers and put in the dock of public opinion, consider why the bankers, politicians, accountants and regulators behaved in the egregious ways that they have. It may be true that all bankers are greedy, all politicians venal, all regulators blind and all accountants stupid. But such personal failings do not explain their behaviour in the past few years. After all, bankers do not like losing money and politicians do not like losing power. All these "guilty men" behaved as they did because they thought it made sense.

And why did these greedy bankers and stupid politicians hold beliefs that, in hindsight, seem so ludicrous and self-destructive? Why, for example, did they think it reasonable for a bank with just $1billion of capital to borrow an extra $99 billion and then buy $100 billion of speculative investments?

The answer was beautifully expressed two generations ago by John Maynard Keynes: "Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back."

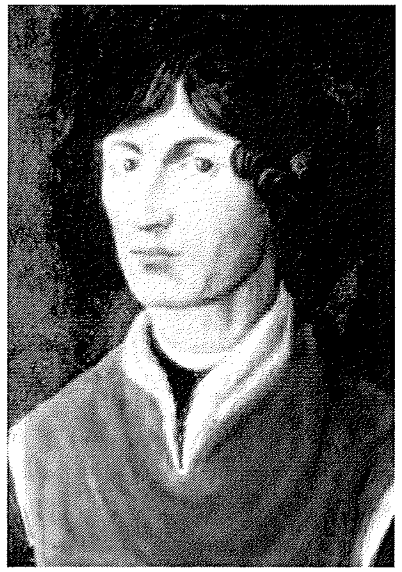
What the "madmen in authority" were hearing this time was the echo of a debate that consumed academic economists in the 1960s and 1970s — a debate won by the side whose theories turned out to be wrong. This debate was about the "efficiency" of markets and the "rationality" of the investors, consumers and businesses who inhabit them.

On those two dubious adjectives "rational" and "efficient" an enormous theoretical superstructure of models, regulatory prescriptions and computer simulations was built. And without this intellectual framework, the bankers and politicians would never have built the towers of bad debt and bad policy that have come crashing down.

I am not suggesting that the bankers who borrowed 50 times their capital to gamble on mortgage bonds or the regulators who allowed them to do it were consciously following academic theories. As Keynes said, these practical men had no interest in theories, which was why they left so many technical judgments to supposedly expert economists and consultants. What the practical men didn't realise, however, was that the risk management consultants who told them their banks would face no solvency problems and the economists who advised them that financial markets were always right were basing their analyses on two theories that were catastrophically wrong.

These two theories — called "rational expectations" and "the efficient market hypothesis" — essentially assume that the economy is a predictable, comprehensible machine with a defined set of instructions. That in itself may seem preposterous, but the theory goes farther and assumes that every "rational" participant in economic life knows these instructions and assumes that everyone else knows them too. To make matters worse, it is then applied to financial markets so that any economically inexplicable gyrations that do occur are explained a way as purely random, like tossing a coin. This leads to the conclusion that financial prices, although they may fluctuate randomly in the short term, are highly predictable in the long term, in the same way that the takings of a casino are.

Why did these implausible theories defeat more realistic ones? Partly it was the ideological mood of the 1980s and partly the ease with which rational expectations theories could be turned into mathematical models. By using these models, bankers and policymakers could be "blinded with science" — and even better from the standpoint of academic economists, their discipline could be elevated to the scientific status of physics.



Economics is where astronomy was before the arrival of Copernicus

The impact on both economics and public policy has been dire. The obvious effect has been the reckless behaviour of bankers and regulators, who were told by reputable-sounding economists that the bankruptcy of Lehman Brothers could be expected only once every billion years or so even though similarly "impossible" events — such as the collapse of the LTCM hedge fund and the 1987 stock market crash — had occurred twice in the previous 15 years.

Equally pernicious has been the stifling of intellectual debate among academic economists, who have spent the past 20 years arguing about the properties of their imaginary mathematical models rather than the behaviour of the real economy these models were supposed to describe.

The question, not only for professional economists but for all those in politics and business who have relied on these ideas, is what will happen to economics now that its fundamental assumptions and mathematical models have been totally discredited by events.

There seem to be only two options. Either the subject has to be abandoned as an academic discipline and becomes a mere appendage of the collection and analysis of statistics. Or it must undergo an intellectual revolution.

The prevailing academic orthodoxy has to be recognised as a blind alley. Economics will have to revert to a genuine competition between diverse intellectual approaches — such as behavioural psychology, sociology, control engineering and the mathematics of chaos theory.

So economics is on the brink of a paradigm shift. We are where astronomy was when Copernicus realised that the Earth revolves around the Sun. The academic economics of the past 20 years is comparable to pre-Copernican astronomy, with its mysterious heavenly cogs, epicycles and wheels within wheels or maybe even astrology, with its faith in star signs.

The academic Establishment will resist such a shift, as it always does. But luckily economists understand incentives. They should now be given a clear choice: embrace new ideas or return their public funding and Nobel prizes, alongside the bankers' bonuses they justified and inspired.