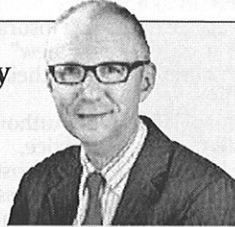


Stop navel-gazing and admit something's wrong

Ben Bernanke's defence of economics merely confirms that it is clinging to outdated and discredited theories

Anatole Kaletsky



Two years ago at the height of the financial crisis, the Queen challenged staff of the London School of Economics with a simple but devastating question: "Why did no one foresee this?"

About six months later the cream of the British economics profession responded with a mealy-mouthed letter of self-justification from the British Academy, waffling on about "a failure of the collective imagination" and "the psychology of denial". Since then the intellectual confusion has only intensified, as we can see by the inability of professional economists in Britain and America to agree on something as important as whether reductions in government deficits will accelerate or slow growth.

What is the use of economics if it cannot answer even such a basic question? Last weekend the world's most powerful economics professor belatedly provided a robust response. Ben Bernanke, the Chairman of the US Federal Reserve Board, one of the most distinguished academic economists of his generation, gave a speech at Princeton, where he spent most of his teaching career, that

confronted the critics head on.

"Some observers have suggested the need for an overhaul of economics as a discipline, arguing that much of the research in macroeconomics and finance in recent decades has been of little value or even counterproductive. Although economists have much to learn from this crisis, calls for a radical reworking of the field go too far. The financial crisis was more a failure of economic engineering and economic management than of economic science. I don't think the crisis by any means requires us to rethink economics and finance from the ground up."

The political world and the financial markets, usually obsessed with every word he utters, paid scant attention; but this was perhaps Mr Bernanke's strangest recent pronouncement. It suggested that the British Academy's

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diagnosis about the "psychology of denial" was right on target and that complacency, far from being eliminated by the crisis, might actually be deeper now than two years ago.

Consider the main examples that Mr Bernanke offered to illustrate the "usefulness" of modern economics: "Bank runs have been a central question in monetary economics since Henry Thornton and Walter Bagehot wrote about the question in the 19th

century. Two centuries of economic thinking on bank runs and panics were available to inform diagnosis and policy response. Central banks around the world followed the dictums set forth by Bagehot in 1873: to avert or contain panics, central banks should lend freely to solvent institutions against good collateral. Invoking emergency powers not used since the 1930s, the Fed was relying on well-developed economic ideas..."

If the most useful economic ideas date back to the 1870s and 1930s, what have academic economists been doing since? The answer, at least for the macroeconomists and theorists who dominate leading universities, central banks and international institutions (as opposed to the industrial economists and investment analysts who work in business and the financial markets), is mostly gazing at their navels.

The economists who claimed that markets are always right or, at least, will automatically correct their own errors, and that the financial gyrations that followed the Lehman bankruptcy could occur only once every billion years, based their analyses on assumptions about "rational expectations" and "efficient markets".

These theories allowed theoretical economists to "prove", with apparently mathematical certainty, that government stimulus policies could do nothing to revive economic growth except in so far as they managed to control inflation. These assumptions and all the conclusions that flowed from them turned out to be wrong.

In reaction, academic economists

have retreated to a second line of defence, which was the main subject of Mr Bernanke's speech. This has been an elaborate exercise in disguising commonsense propositions with mathematical flummery — what Ha-Joon Chang, the Cambridge development economist, characterises as "common sense made complicated".

The platitude that bankers pursue their own interests, not those of shareholders, is known as "principal-

They use mathematical flummery to disguise commonsense ideas

agent theory"; the observation that successful currency traders make money by following trends created by other traders instead of analysing economic fundamentals has been elevated into "behavioural economics"; that unscrupulous mortgage brokers can wreck the housing business as readily as unscrupulous car dealers can wreck the market for used cars is renamed "asymmetric information".

What a contrast to these platitudes were the genuinely revelatory ideas of the great economists: Adam Smith's insight that self-interest generally serves society better than altruism; David Ricardo's argument that the best retaliation against protectionism is often free trade. Why has economics stopped generating such important ideas? And does it matter?

One reason why economics has

progressed so little beyond the insights of its founding fathers has been the convention adopted since the 1960s that all serious economic ideas must be expressed in equations, not words. By this weird standard, the work of the genuine giants — Smith, Ricardo, Keynes, Schumpeter, Hayek — would be rejected by academic journals and would not be recognised as serious economics at all.

More importantly, economic theory has become a branch of political ideology. In an era when income inequality was increasing and politicians were abandoning economic interventionism, these trends could be legitimised as the requirements of economic efficiency and the inevitable outcome of market forces.

The economics of rational expectations and efficient markets has gradually acquired a virtual monopoly on senior university appointments and research funding. This monopoly, in a process familiar to all economists, has ended up not just crushing competition but also destroying itself from within. As long as central bankers such as Mr Bernanke or, for that matter, Mervyn King, pay lip service to clearly discredited concepts, it is hardly surprising that confidence is lacking in their ability to manage the economy. To rebuild confidence in economics, the first step is to admit that something has gone wrong.

Anatole Kaletsky is on the board of the Institute for New Economic Thinking, which will announce its first round of research grants next month