

**The Economic Crisis and The State of Economics edited by
Rober Skidelsky and Christian Westerlind Wigstrom,
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55, pp 123.**

‘...Good economists are scarce because the gift of using ‘vigilant observation’ to choose good models, although it does not require a highly specialized intellectual technique, appears to be a very rare one...’

J M Keynes

The Telegraph from London reported on November 5, 2008 “... during a briefing by academics at the London School of Economics on the turmoil on the international markets the British Queen asked: ‘Why did nobody notice it ?’...” “..if these things were so large how come everyone missed it...” These questions have been harping in the minds of millions across the globe. A sense that the economists failed to see the financial crisis brewing has led to soul searching among many economists around the world, ever since the global financial crises exploded. While some did warn that home prices were forming a bubble, others confess to a widespread failure to predict the damage the bubble would cause when it burst. Some economists are arguing that a free-market bias in the profession, coupled with outmoded and simplistic analytical tools, blinded to the danger. Dahlem report condemned as growing reliance over the past three decades on mathematical models that improperly assume markets and economies are inherently stable, and which disregard influences like differences in the way various economic players make decisions, revise their forecasting methods and are influenced by social factors. There are strong views that standard analysis also failed, in part, because of the widespread use of new financial products that were poorly understood, and because economists did not firmly grasp the workings of the increasingly interconnected global financial system. Allen F (2009) is of the opinion that ‘...economists used mathematical models that failed to account for the critical roles that banks and other financial institutions play in the economy...’ Further, he stated that they

simply didn't believe the banks were important. Likewise, the global financial crises, not only kicked up a lot of debate on the international financial crisis *per se*, there are stronger views on market economy stating as 'moral crisis of capitalism' and others often compared the crises with the 'Great Depression'. Predictably scores of conferences, symposiums were conducted by different forums across the world to seek explanations. This book is an outcome of collection of papers presented in one such symposium organised in February 2009, partly inspired by the general dissatisfaction with the silence of economics profession on the causes of and the remedies for current economic distress. The participants in the symposium were world renowned economists, who came out with divergent views not only on the causes of crises but also on the very subject 'economics'. This book is neatly edited and presented with all the conference papers in the form of separate chapters.

The book is extremely interesting to read, scintillating and thought provoking as well. There are ten chapters in all, which the editors have aptly grouped under three broad heads, viz., Part I : Risk and Uncertainty in Economics, Part II : Macro-Economics and the Current Crisis and Part III: Models, Metaphors and Morals. Besides the above, the editors eminently summarized the entire presentations of papers and the discussion in the conference in the form of Chapter 1: Introduction. According to the editors, the three main themes emerged from the papers and the discussions that followed are 'the question of whether future events are a matter of uncertainty rather than risk; the impact of global macroeconomic imbalances; and the role of economic models. These three main themes clearly emerges out of the papers presented.

Paul Davidson in his paper 'Risk and Uncertainty' strongly advocates a view of the future as irreducibly uncertain. Unlike in the "hard sciences" such as physics or astronomy, in economics, there is no foundation on which to base any probabilities about future events. While astronomers can be reasonably confident that a planet will appear in a predicted place at a predicted time the same cannot be said about many subjects of interest to economists. Probabilities calculated on past and current market data cannot be taken to hold about future

events since, as he argues, there is no way of knowing what social and economic events will occur in the future. Thus, the future is not “ergodic” - it is not predetermined. Yet, the ergodic axiom is at the heart of key theories such as the efficient-market hypothesis which states that markets determine price of the assets correctly based on all available past and present information. Without the possibility of assigning actuarial probabilities to future events, the value of assets cannot be efficiently established. In effect, the efficient-market hypothesis assumes that all uncertainty can be reduced to calculable risk. The failure to recognize this fallacy has led to the bankruptcy of major financial institutions such as AIG as well as a false sense of security which paved the way for panic once the foundations trembled. Therefore, Davidson makes a case for the introduction of a “market maker” an institution that takes up responsibility for keeping the market liquid in the face of unforeseeable events, in order to lessen the effects of uncertainty. Sujoy Mukerji in his paper “Ambiguity and Economic Activity Implications for the Current Crisis in Credit Markets” reinforces Davidson’s view on irreducible uncertainty as an explanation for the crisis. In situations of uncertainty it is often the case that the decision maker’s knowledge about the probability of contingent events is consistent with more than one possibility. Under such conditions it is rational not to act. In financial markets this leads to a situation in which more ambiguity results in less trade and lending. In the words of the author : “...the uncertainty is triggered by unusual events and untested financial innovations that lead agents to question their worldview...” In the sense that, rather subjecting investments to incalculable risks no investments are made at all and instead, people hoard cash - an idea conforming to “Keynes’s liquidity preference theory”. Therefore, the author concludes that the present crisis can be understood as having erupted because of increasing uncertainty amidst rapid financial innovation. Significantly, this also corroborates an idea related to the discussion in Richard Bronk’s chapter : Models and Metaphors. At some point investors and banks withdrew their capital and credit, leaving consumers and companies in lurch and ultimately themselves too. This suggests that a policy promoting transparency and other uncertainty-reducing objectives could mitigate the financial downturn and ease credit markets.

Therefore, we are in need of qualitative rather than quantitative easing. Marc Potters, on the other hand, in his chapter on ‘Lessons from Finance’ did not strongly dismiss the ability of economic modeling to assign accurately probabilities to future events. He opines that, the future is not exclusively characterised by irreducible uncertainty. Potters further argues that, rather than facing a principal problem with uncertainty, influential pricing models have typically relied on assumptions too simple to have any relation to the reality they seek to predict. For instance, the Gaussian process assumed in the Black- Scholes option pricing model imply a disregard for the relative frequency of extreme fluctuations observed in the empirical data. In contrast to the assumptions of this model, volatility is not constant. The invalidity of these assumptions implies that there can be no zero-risk options as the model predicts. In other words, “option trading involves some irreducible risk.” Moreover, conventional wisdom in mathematical finance treats prices as “god-given,” yet feedback loops indicate that this is fundamentally wrong. Large purchases of assets increase their price thereby prompting further purchases, or conversely decreasing prices result in investors selling thereby further lowering the price. In effect, the financial crisis can be explained by means of such a positive feedback loop. Under such circumstances the degree of correlation among instruments changes, however, such a consideration seldom included in financial mathematical models. In practice, mathematical tractability and methodological consistency have made these models attractive, despite their flaws. Significantly, Potters also cautioned stating that ‘diversified portfolios do not reduce risk as soon price movements are correlated’. However, if the models were better understood and improved there is scope for modeling to reduce the degree of uncertainty in the economy. The problem is that a lot of people can make huge amounts of money by *not* understanding the models they are using. This draws similar opinions of Christopher Bliss in his chapter ‘Globalisation and the Current Crisis’ who emphasised on asymmetric information. He blamed bankers provide credit to investment projects they have only very limited information about. Rating agencies and diversification of asset portfolios are intended to reduce the risk associated with asymmetric information, yet the rating agencies have incentives to

award higher ratings than deserved. Thus, according to Bliss, “market function poorly, if they function at all, in situations characterized by asymmetric information” and this problem is exacerbated when the distinction between investment and retail banks is blurred and “safe” deposits end up being used for speculation. It is significant to note that, once the bubble bursts the crisis migrates quickly from finance to the real economy. However, asymmetric information only explains the speculative side of the crisis and does not explain how consumers in the West could enjoy low inflation, cheap money and high profits at the same time, all of these fuelled an unprecedented growth in credit.

Bliss argues further, that competition from East Asia, predominantly China, was responsible for the present crisis. A Chinese “saving glut” in the form of enormous investments in American Treasury Bills kept the Chinese currency artificially low and made Chinese companies super competitive. Cheap imports kept prices low while cheap Chinese labor stifled the increase in Western real wages. In effect, the resulting imbalances led to a situation in which East Asia financed Western current account deficits. Vijay Joshi in his paper titled ‘Global Imbalances’ takes a similar stand but of the view that the origins of the Asian saving glut by referring to two projects; the creation of foreign currency reserves as a precautionary buffer, the value of which the East Asian countries understood after the 1997 financial crisis: and the policy decision of these states to pursue export-led growth as a means to economic development. Both of these missions were facilitated by keeping their own currencies low relative to the reserve currency, i.e. the dollar. Further, this was achieved by investing heavily in the American credit markets. The ensuing macroeconomic imbalances were not sustainable in the long run. Joshi further argued that if the American house prices had not fallen, an adjustment process would have started with a fall of the dollar. As a suggestion, Joshi advised that in order to forestall similar bubbles appearing in future, central banks, must look beyond consumer price indices as key indicators of the health of the economy and need to look at asset and credit price movements too. He also called for strengthening of key financial institutions such as the IMF to prevent the creation of unsustainable imbalances on an international level. The world needs a “neutral” reserve currency and agreements on exchange rate regimes. Although

macroeconomic theory cannot be blamed for global imbalances, it shows weakness in its inability to foresee these consequences. In part, this weakness stems from reliance on inappropriate models.

John Kay in his chapter “Knowledge in Economics” emphasized that ‘the test of an economic model is whether it is useful rather than whether it is true’. He stated that one should not be concerned about whether the efficient-market theory is true or not and in fact, he said it is neither. Markets are often efficient but economists take this to mean that they are always efficient. Information is included in prices but it is not necessarily correctly weighted. The same goes for views on risk as well. The ‘theory of subjective expected utility’ is neither true nor false. Economic theories are metaphors and models and not realistic descriptions. We need to be able to choose when to use which metaphor. “The skill of the economist is in deciding which of many incommensurable models one should apply in a particular context.” Keynesian uncertainty which considers confidence, narratives and degrees of belief in those narratives has all but become extinct and yet Keynes’s perception of risk is no less important than the dominant classical risk paradigm. He advised that economists need to be more eclectic in the set of models they use. Otherwise will end up in the situation described by Charles Goodhart in his chapter ‘Macro-Economic Failures’ which describes how Dynamic Stochastic General Equilibrium (DSGE) models work well in good times when default rates on loans are low but badly in bad times. In part, he attributes this weakness to the transversality condition which stipulates that an economic agent has used all his resources and paid all his debts by the time he dies. Further, he observed, that it hardly corresponds to the reality. He underscored that amongst economists, a flawed but rigorous theory often beats a correct but literary exposition and this has led to an over confidence in markets based on rigorous but incorrect theories such as the efficient market theory. However, there is a large difference between what academic economists think and what businessmen do. Given that economists and financial practitioners accept that prices can move away from fundamentals, it is absurd to count on the efficient ‘market theory’. Consequently, our standard macroeconomic models which virtually everybody has been using, tell us absolutely nothing

about our present problems. This was also the strongest contest by Richard Bronk's paper : Models and Metaphors. Despite rapid innovation which imparted dynamism and uncertainty, economists and the businessmen rely heavily on equilibrium models. He concluded with the remarks that world as we see it is to some extent, a creation of our minds. Likewise models that we use structures the way we analyze and interpret what we observe. In simple words 'ones perspective affects one's view' the tendency of the contemporary models to treat uncertainty as risk has had huge consequences for the world economy into crisis. This is similar to what Davidson and Mukherjee also stated. Thus, Bronk concluded that there was something absurd in relying so completely on risk models based on past data when bankers going ahead with innovating newer products on weekly basis.

Lord Meghnad Desai in his Chapter : 'Hayek : Another Perspective' suggested that we should look at the ideas of Hayek to get better inkling of the unfolding of recent events. Hayek combined Walras and Money to explain business cycles. Credit creation by the banking system produces overinvestment in relation to voluntary saving. The overinvestment can be kept going only at the cost of increasing inflation. In such a situation any increase in interest rates forces the banks stop lending and cut down the existing loan sanctions. Which in turn makes the investment projects to collapse and the economy contracts. According to Hayek, as pointed out by Desai, there should not be build up of the credit by the banks at the first count. Desai pointed out further, Hayek was trying to talk about a crisis in terms of the banking system being the principal source of trouble. The resent crisis was much in line with what was visualized by Hayek long back. He suggest that there are more models than just the Walrasian and Keynesian. Even in the case of Keynes, there used to be multiple models out of Keynes, more than we have today. Therefore, he suggests that it is time for practitioners and thinkers to dig out and ponder over Hayek's philosophy.

The last chapter titled 'Economics and Morals' by Robert Skidelsky is very interesting to read and it traces the subject 'Economics' from the days of F Y Edgeworth 1881 who wrote that the first principle of economics is that every agent is actuated by only 'self interest'. With varied definition of economics coming into existence Skidelsky

argued that what was mentioned as self interest by Edgeworth is interpreted as ‘egoism’ according to him. Egoism remain implicit in the method of economics, even if it no longer features explicit as a first premise and it permeates the whole range of human purposes right upto ‘spiritual’. In the sense, economists tend to treat all ends as ‘measureable’ and unfortunately assess them along single dimension. In the process the diversity of human goods reduced to a series of benefits of varying degrees of magnitude. In this context, he stated Robbins is disingenuous in claiming that economics has ‘outgrown its hedonistic origins’. However maintained that ‘...the Pig-Philosophy may have proved all-embracing, but pig-philosophy it remains...’. Ultimately the Author is of the view that the economic approach cannot be valid as a general theory of human behavior.

In sum, the book is extremely interesting and a necessity for reading by all students of economics, professional economists and practicing policy makers. Those who believe strongly on the power and utility of models and those who strongly question the utility of such propositions, both need to read and understand where the fault lies. The book as a whole is scintillating and thought provoking. I must quote ‘...the beauty of General Theory of Employment, Interest and Money was that it was ‘general’ enough to accommodate a variety of “models” applicable to different states of expectations...’. Therefore, it is absolutely necessary to choose the right models to the right situation rather than rejecting the usefulness of models in macroeconomics and finance.

Given their pre-eminence position in the field of economics, the authors could have made more explicit suggestions/ precautions as to how to prevent such crises of monstrous magnitude in future as that would help for the readers and policy makers to take precaution.

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