

THE FUTURE OF ECONOMICS: RESEARCH, POLICY, RELEVANCE

JOHN QUIGGIN
UNIVERSITY OF QUEENSLAND

PLENARY ADDRESS TO AUSTRALIAN CONFERENCE OF ECONOMISTS, MELBOURNE, 10
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THE PRESENT: CRISIS AND COMPLACENCY

- Policy crises on multiple fronts
- Research
 - Largely irrelevant to key policy problems
 - Driven by internal professional incentives, demands of finance sector
- Economists seem largely unconcerned

SOME REAL ACHIEVEMENTS

- Since 1970s, microeconomics has made significant progress
 - Asymmetric information
 - Risk and uncertainty
 - Mechanism design
- Applications to auctions, insurance, matching markets

BUT MUCH BIGGER FAILURES

- ❖ Macroeconomic theory has proved useless
- ❖ Finance promoted light-handed regulation, actively helped to cause crisis
- ❖ Public economics has weakened capacity of governments to respond

THE GFC AND AFTER

- Sustained high unemployment
- Comparable to Great Depression in worst-hit countries
- Repeated financial market failures
- Governments crippled by cost of bailouts

POLICY IN CRISIS

- ❖ Failure of the market liberal model
- ❖ Absence of a coherent alternative
- ❖ Policy failures in macro, finance, public economics

MARKET LIBERALISM

- Ideas that dominated the late 20th century and early 21st
- Appeared successful in 1990s and early 2000s
- Gave rise to global financial crisis
- Failed, but continue to dominate

CORE IDEAS OF ECONOMIC LIBERALISM

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 The Great Moderation

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- Efficient Markets Hypothesis

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- Privatisation

ZOMBIE ECONOMICS

HOW DEAD IDEAS STILL WALK AMONG US

PRIVATIZED SOCIAL SECURITY!



TRICKLE-DOWN ECONOMICS!



EFFICIENT FINANCIAL MARKETS!



A CHILLING TALE BY **JOHN QUIGGIN**

MACROECONOMICS AND THE NEW DEPRESSION

- Biggest macro event since 1970s crisis
- Arguably since Great Depression
- Not predicted
- In fact the opposite (Great Moderation)
- No accepted explanation
- No agreement on policy response

DSGE

- Dynamic Stochastic General Equilibrium
- Micro-based macroeconomics
- Representative agent optimising over
 - Time (**Dynamic**),
 - Uncertainty (**Stochastic**),
 - In all markets (**General**)
 - To match supply and demand (**Equilibrium**)

HAIKU

- A macroeconomic article today often follows strict, haiku-like, rules: It starts from a general equilibrium structure, in which individuals maximize the expected present value of utility, firms maximize their value, and markets clear. Then, it introduces a twist, be it an imperfection or the closing of a particular set of markets, and works out the general equilibrium implications. It then performs a numerical simulation, based on calibration, showing that the model performs well. It ends with a welfare assessment.
- Olivier Blanchard, IMF Chief Economist

FAILURE

- ❖ No use in predicting or resolving the Great Recession
- ❖ It is as if, as the Titanic was sailing into iceberg-infested waters, those with the requisite skills and training to warn of the impending danger were instead hard at work, in a windowless cabin, perfecting the design of ship hulls ... for a world without icebergs
- ❖ David Gruen, Treasury

(IR)RELEVANCE

- Major policy debates do not draw on leading edge theory
- Case for austerity
 - Anecdotal/case study evidence
- Case against:
 - New Old Keynesianism

WHAT DO WE NEED

- More realistic understanding of individual behavior
- Bounded rationality
- Social interactions and aggregate effects
- Primary focus on relevance and applicability

FINANCE & EFFICIENT MARKETS HYPOTHESIS

- Strong versions of EMH suggest financial markets best guide to policy
- Discredited by dotcom bubble and bust, then by GFC
- Still the basis for most research in finance theory

EXCEPTIONS THAT PROVE THE RULE

- Diamond and Dybvig on bank runs
 - Not taken seriously in design of light-handed regulation
 - Basel II
- Theory of rational bubbles
 - Mainly focused on bubbles that never burst
 - Hence sudden boom/bubble of interest in Minsky

THE GFC AND AFTER

- Financial markets produce catastrophic mispricing
- Light-handed regulation routinely subverted
- LIBOR
- Too interconnected to fail, too big to save

FINANCIAL DEREGULATION IN RETROSPECT

- Initial success followed by catastrophic failure
 - Australia in 1980s and 1990s
- Global system and GFC
- Do costs outweigh benefits
 - Plausible calculations say "Yes"

WHAT DO WE NEED

- Models with instability built in
- Focus on robustness of measures to prevent large-scale crises
- Structural separation, narrow banking, restrictions on financial innovation

GROWING INEQUALITY

- Strikingly evident in US
- Apparent in most English-speaking countries
- Australia a partial exception
- Efficiency-based defences
- 'Trickle down'
- Unequal outcomes and unequal opportunities

CAUSES OF INEQUALITY

- Decline of unions
- Rising profit share
- Shifts in tax policy
 - Flatter income tax scales
 - Shift from direct to indirect, capital to labour
 - End of wealth and estate taxes
- Trends supported by economic theory

THE US EVIDENCE

- Most growth has gone to top 1 per cent
- Within that group, to top 0.1 and 0.01
- Declining median household income
- Low and declining income mobility
- A picture of the global future?

WHAT WE NEED

- More and better empirical evidence
- Particularly on top incomes
- Better understanding of intergenerational transmission

PRIVATISATION

- ✦ Use of term began Thatcher
- ✦ Reversal of long trend towards greater public ownership
- ✦ Rejection of the mixed economy
- ✦ Claim that all productive activities should be undertaken by private sector

WHAT WE NEED

- Better understanding of balance between public and private
- Theory of optimal public debt

FAILURE

- ❖ Initial promise of dynamism not delivered
 - ❖ New Zealand an extreme case
- ❖ Theoretical rationale discredited
 - ❖ Equity premium problem
- ❖ (re)nationalisation
 - ❖ Railtrack, AIG, Northern rock

WHAT DO WE NEED?

- More realistic micro-foundations
- Behavioral economics
- Understanding of aggregate phenomena
 - Trust, social networks
- Models of disequilibrium

ECONOMIC RESEARCH

- Driven largely by internal imperatives
- Structure of US academic labor market
- "PhD variation" on established research agendas
- Rigorous analysis of narrow topics
- Little room for big picture

NEED TO CHANGE REWARD STRUCTURES

- Policy work vs publications
- Books and blogs vs journal articles
- Public engagement

CRISIS, COMPLACENCY, AND RELEVANCE

- The global economic crisis should have produced a crisis in economic theory
- Instead, business as usual
- A path to inevitable irrelevance

WHERE TO FROM HERE?

- Need to rethink C20 experience
- Understand success and failure of postwar Golden Age
- Economics should focus:
 - More on realism and relevance, less on rigor
 - More on equity, less on efficiency
 - More on humility, less on hubris

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