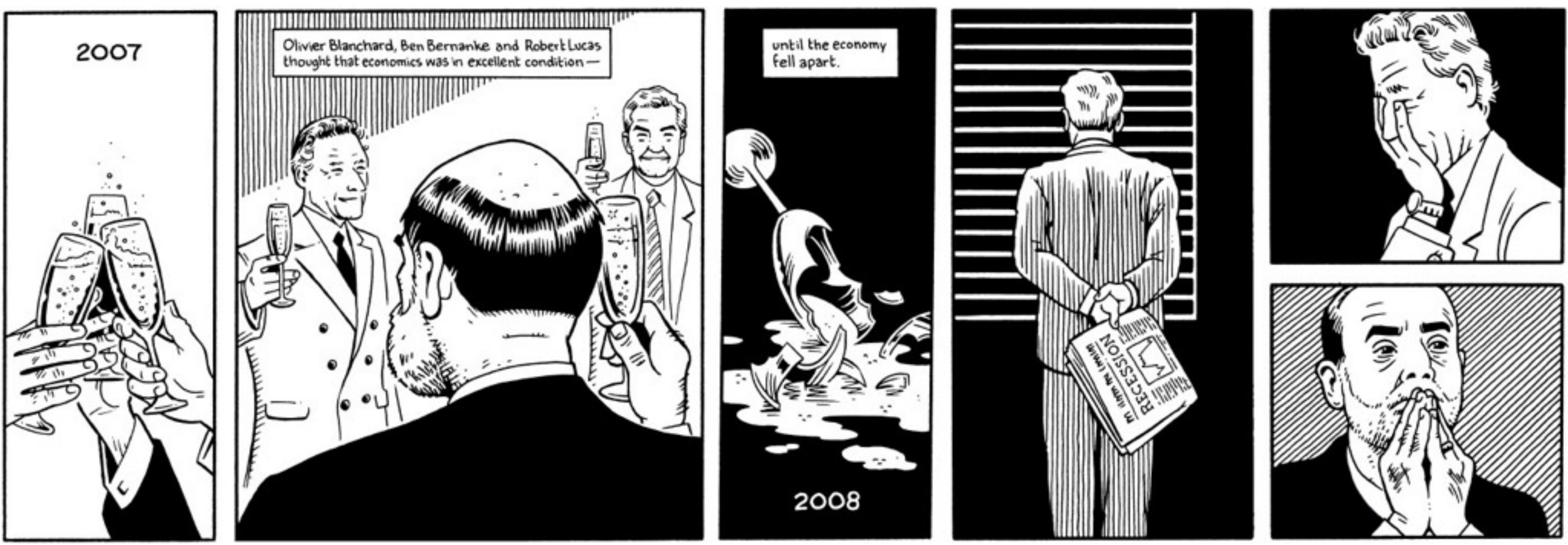
The Financial Crisis

Did Macroeconomics Fail?



Recommended

- Krugman (2009), "How did Economists get it so Wrong?"

Optional

- Cochrane (2009), "How did Paul Krugman get it so Wrong?"

Background

- The Economist, "The Slumps that Shaped Modern Finance"
- The Economist, "The Origins of the Financial Crisis"
- Postlewaite et al. (2011), "Economic Models as Analogies"
- Pfleiderer (2014), "Chameleons: the Misuse of Theoretical Models in Economics and Finance"

Concepts / Terms

- Rational Expectations
- Efficient Markets Hypothesis
- Microfoundations
- DSGE Model
- Neoclassical vs. Neo-Keynesian

Krugman (2009)

- “The state of macro, in short, is not good.”
    - Prioritizes mathematical consistency and tractability over empirical validity
    - Based primarily on the assumptions of “perfect rationality” and “perfectly efficient markets”, which ignore the “flaws and frictions” of real economies
- Alleged dismissive attitude towards those who dissent with standard assumptions or policy prescriptions
    - Mentions Rajan's (2005) warnings that were both prescient and ignored
- Old Keynesian models, irrationality, herd behavior, behavioral finance all have a place in our understanding of the business cycle
- Future macro will have to deal with the “messy” reality, and be more humble with regards to its policy advice

Rajan (2005)

- Great expansion in availability and complexity of financial instruments
  - Better and more fine-tuned allocation of risks in the economy
  - Supports more risk, but amount of risk has also increased, could lead to unlikely but severe crisis
- Misalignment of incentives between investors and financial intermediaries: tail risks, herding behavior, short-term incentives
- “The prudential net may have to be cast wider than simply around commercial or investment banks.”
- Does not predict a crisis, sparse emphasis on mortgage practices, but is otherwise spot-on

Cochrane (2009)

- A failure to predict the crisis is a key prediction of the efficient markets hypothesis
  - “This is probably the best-tested proposition in all the social sciences.”
- The case for the free market is not that it’s perfect, but that the government can’t do better
- “Irrationality” is an empty proposition, can explain anything
- “Beauty” of macro lies first in logical consistency, unlike Keynesian theory which requires agents to repeatedly hold incorrect beliefs and partially ignore the future.
- Macroeconomists have been working on “flaws and frictions” for decades

My Opinion

- Agree with Cochrane
    - Rigor: better to say something limited but correct and precise than to say something general but vague and flawed
    - Crisis was not predictable… at least in its particular form and at the particular time
- Agree with Krugman
    - Policies were flawed, applications of models without full appreciation for the limitations of their assumptions
    - Lack of appreciation for demand-driven slumps

My Opinion (cont.)

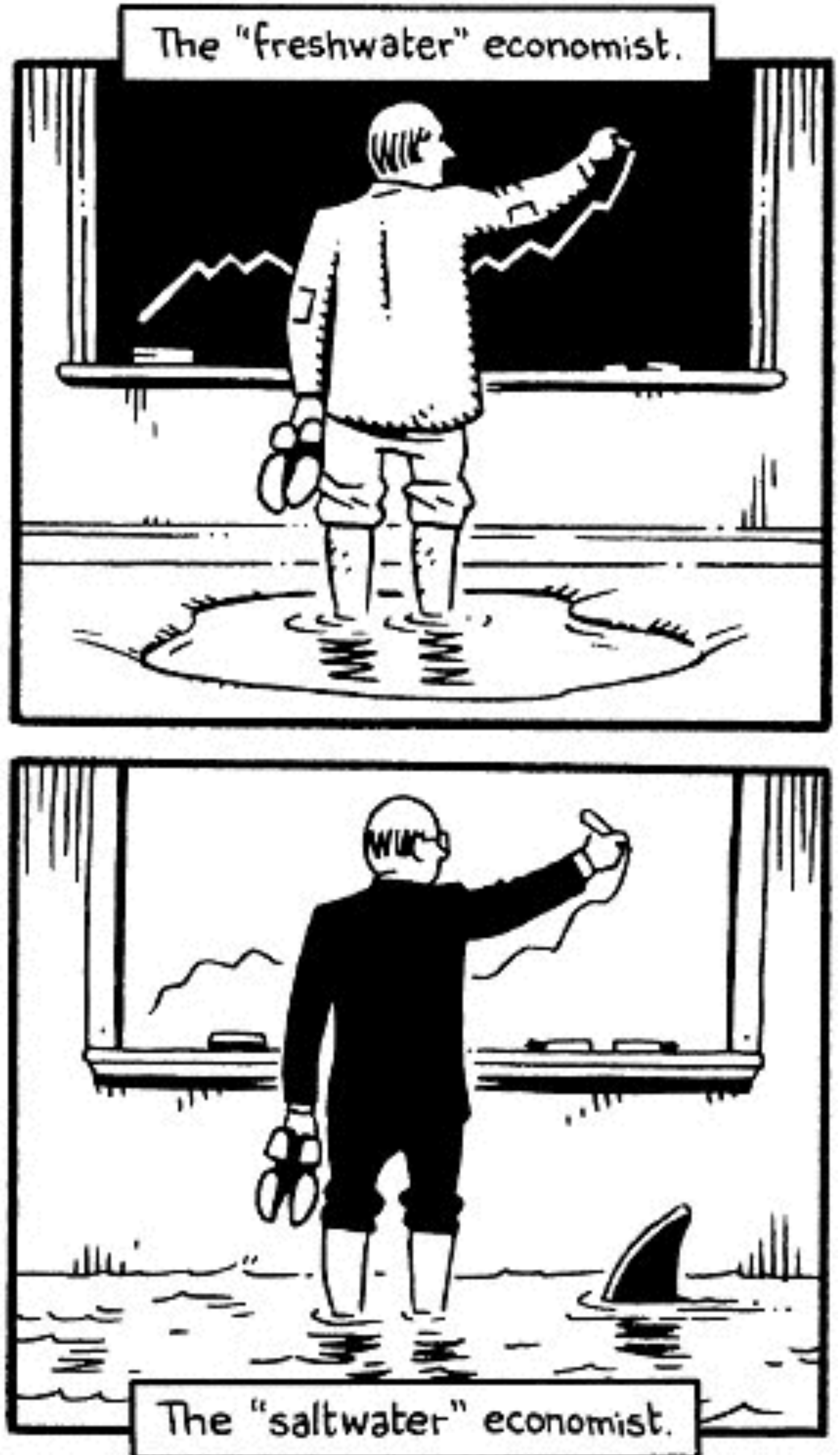
- Criticism should focus less on rationality and more on environmental assumptions - perfect information, no frictions, homogenous populations, lack of institutional structure, etc. But recognize these are hard problems…

- The term "rational expectations" is misleading… should say equilibrium behavior or (almost equivalently) correct beliefs

    - In many models, there's a unique equilibrium. In the real world, even if there is a unique equilibrium, in practice it's impossible to determine what it is. Correct beliefs marks a fundamental departure from reality.

Questions

- What should the macro research program focus on over the next decade?
- Does the efficient markets hypothesis excuse the field and policy-makers?


The "freshwater" economist.
The "saltwater" economist.