Gresham's Law in Economics: Background to the Crisis Transcript

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Sir Thomas Gresham, founder of this College, has amongst his many distinctions an economic Law named after him. Gresham's Law is succinct: ‘Bad money drives out good’. It applies to a monetary system based on coins minted from precious metals. Coins carry images of the state (the monarch’s head, heraldic emblems) as an assurance of their weight and fineness, so that they circulate at their face value. When some coins are clipped or otherwise debased, their intrinsic value diverges from their face value. People will circulate the debased coins; the good coins are melted down or sent abroad (where their value is established by assay) to realise their intrinsic value. The good money is driven out of circulation in its home country.

I shall argue in this lecture that something similar has happened in economics: far from there being progress in economics, bad economic theory has driven out good theory.

If economics were an ivory tower discipline, that would be merely unfortunate for a small band of scholars. But economics may influence the future of its own subject of study! This is very obvious in the case of the present crisis: the fingerprints of bad economic theory are all over the policies that helped to create the present crisis, and unfortunately they are shaping the policies employed to deal with it as well. So everyone is affected by this state of affairs. We are all paying the price of the success of bad economics, and you deserve to know something about it and how it has come to be so dominant within the economics profession and influential outside it.

Most of you will have read in the papers in 2008 that the Queen, opening a new building at the London School of Economics, was entertained (if that is the right word for it) to an explanation of the banking collapse, sometimes called the ‘credit crunch’, complete with diagrams. She asked ‘Why did no-one see it coming?’ Professor Garicano was reported as replying that ‘At every stage, someone was relying on somebody else and everyone thought they were doing the right thing.’

If, as I assume, he was referring to the market participants, his reply is more cogent than it sounds. There are substantial incentives for speculators to follow the herd. But the great majority of economists didn’t see it either. Willem Buiter, founder member of the Monetary Policy Committee, cut to the heart of the matter: mainstream macroeconomic theories, he wrote, ‘not only did not allow questions about insolvency and illiquidity to be answered. They did not allow such questions to be asked.’ There was no place in these theories for illiquidity and insolvency. They couldn’t happen. But they did happen.

Another answer to the Queen’s question is even worse, for it exposes something unpalatable at the heart of economics. The collapse of the banks wasforesseen, by many individuals and even in key institutions like the Bank for International Settlements. But their warnings were not heard, either by mainstream economists, for whom such outcomes couldn’t happen, or by policy-makers and regulators, whose thinking had been guided by this kind of economics. One economist called the banking collapse ‘the most predicted crisis in history’, and the list of the forecasters is impressive. But such is the power of the monoculture which mainstream economics inhabits that important warnings were ignored. They did not fit the shared belief system. Those who predicted the crisis were outside the club. To the mainstream, they were nobodies; and nobody saw it coming.

Some did see it coming, so there must be some good theory out there. It is time to address the Thorny question of what I mean by good and bad economic theory. Then I shall explore how bad theory has managed to drive out good.

Good and Bad Economic Theory: No Room for Illiquidity or Bankruptcy
It should be easy to agree that a theory that has no room for illiquidity or bankruptcy is a bad guide to the crisis of 2007-8. Where does this theory come from? It arises from a foundational element of mainstream economics called rational choice theory. The idea is that everyone has a set of preferences for a variety of economic goods and maximises their acquisition of them subject to a budget constraint. To get what they want they may sell some of the goods that they have. So we have supply and demand. Enter another key assumption: that prices are determined by supply and demand and that markets always clear. From this it is concluded that markets, and prices, reflect all relevant information.

When applied to something which is wanted only for its monetary return, such as financial assets, the fact that the asset’s price may vary between the time when it is bought and the time it is ‘cashed in’ must be taken into account. To accommodate this risk, the asset’s future price is modelled as a probability distribution, based on the past behaviour of its price. Then once again the market is assumed to do its work: risk is appropriately priced.

This result is further generalised in what is called the efficient markets hypothesis, which says that markets take full account of all publicly available information in forming prices and are therefore efficient in allocating capital to the best uses. One branch of mainstream theory allows for ‘asymmetric information’ (you may know something
that I don’t), and the possibility that markets do not clear, but the perfect market remains the benchmark. Departures from it are called ‘imperfections’, ‘rigidities’ or ‘market failures’. This is why this group is still counted as part of the mainstream.

If the efficient markets hypothesis is true and everyone believes it and acts on it, then all assets are equally liquid: the value the market places on any security is the correct price and any asset can be sold immediately at that price.

This is already quite enough nonsense, but there is more: The theory of rational choice has been further generalised into a theory of complete markets: it is proposed that there are markets spanning all possible future contingencies and outcomes, in which agents maximise their acquisition of their preferred economic goods and assets subject to the constraint of income and their ability to borrow at all future dates. Since the budget constraints are assumed to be honoured and future contingent demands are known, bankruptcy is impossible. It is a perfect world. It is also a world which would exhaust human computational power and the resources to run such markets, but it is one of the central ideas of mainstream theory.

The trouble is, economists believe the results of their theory, and they advise policy-makers. This perfect world has influenced policy, through which actual institutions have been re-fashioned, more closely to resemble the perfect markets of theory. If markets are efficient, liquidity is no longer an issue, so let us relieve the banks of the burden of carrying low-yielding liquid assets. Liquid asset ratios required of UK banks were reduced successively from 1971 onwards, and in 1998 they were abolished; the holding of liquid assets became voluntary.\[3\] The bank thus entered the crisis with no first line of defence. Holdings of liquid assets have increased since the crisis broke, but they are still very small.

Similarly, banks were allowed to assess the risk of their own assets for the purpose of setting their Basle capital requirements under Basle II, on the grounds that they knew the markets best. And the Financial Services Authority, charged in 1997 with bank supervision, saw competition – i.e. the market - as the main means by which banks were controlled. It will be interesting to see what approach the Bank of England takes when supervision returns to them shortly.\[4\] It is to be hoped that recent experience will introduce some scepticism about the efficiency of markets.

Alan Greenspan, former chairman of the Federal Reserve System, relied on markets and self-interest of the banks until the crisis forced a re-think:\[5\]

Those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity, myself included, are in a state of shocked disbelief.

Basic Principles of Mainstream Economics, continued

In this one example of illiquidity and bankruptcy I have introduced the following key aspects of mainstream economic thinking:

Agents have stable preferences over the set of economic goods, including contingent preferences into the indefinite future.
Budget constraints and contracts are respected: no one steals or fails to repay a loan.
Markets always clear: supply equals demand. This is an assumption, not a result. It is called equilibrium.
Risk can be understood by probabilities which in practice are derived from past data.

I cannot stress enough the importance of these ideas to mainstream thinking. So central are they, that any work not based on them, at least taking them as a reference point, does not count as economic theory within the mainstream.

Unspoken, but very much part of the thinking, is the assumption that the choices of individuals can be aggregated to form ‘markets’ without worrying about interaction between them except through those markets. This is called the atomistic assumption. Finally, I also sneaked in, in the phrase ‘and everyone believes it’, what is called ‘rational expectations’. This principle asserts that, perhaps after a period of learning, expectations of, say, future prices will not differ systematically from the equilibrium that the model predicts. To differ would be to court losses. You will notice that it is assumed that the model is correct, but of course if everyone believes it and acts according to it, it will be correct, until some constraint not included in the model – for example defaults on mortgage payments – brings self-fulfilment to an end.

These ideas are normally hidden behind a smoke-screen of mathematics. Seeing them stated so baldly, I am reminded of Keynes’s warning about formalistic exposition (in which most economic theory is expressed):

“It is possible, under the cover of a careful formalism, to make statements which, if expressed in plain language, the mind would immediately repudiate.”\[6\]

Repudiate because the assumptions made are so strong and so far removed from everyday experience. What accounts for the construction of such a theory, and why is it deemed acceptable by so many?

Theory Construction

All theory abstracts from complex reality in order to arrive at some basic principles. The problem is what
abstraction to make and where to start. There are two starting points: start from some self-evident, simple statements and deduce conclusions, or start from an appreciation of reality and abstract the salient features and try to find causal connections. We can call these Idealist and Realist approaches. [7]

Theory Construction: The Idealist Approach
Modern mainstream economics is relentlessly idealist. It views the basis of rational choice theory in preferences and constraints as axiomatic and the theory itself as foundational. Some have even gone so far as to say that unless a theory is based on its principles it is not really economics. The rhetorical force of the word ‘rational’ here is very powerful, for who would base theory on irrationality? But it is a very narrow conception of rationality.

Similarly the concept of equilibrium is clung to as a drowning sailor clings to his mast: “There is an equilibrium when all individuals are choosing the quantities, to produce and consume, which they prefer. To a conception of equilibrium that is of this type, we must hold fast.” [8]

J. R. (later Sir John) Hicks was only thinking of the necessity of an equilibrium solution, not that it was the only possible state of affairs. For Robert Lucas, perhaps the most celebrated mainstream theorist today, equilibrium applies continuously. He has described disequilibrium as ‘arbitrary’ and ‘unintelligible’. [9]

For Lucas, a theory is an analogue model economy, built to mimic the features of the economy that the theorist wishes to analyse – for example, it exhibits cyclical fluctuations if the theory wishes to analyse business cycles. Lucas describes these models as ‘artificial, abstract, patently “unreal”’. [10] Debreu went even further. He set out to formulate a theory of value which was “in the strict sense, ... logically disconnected from its interpretation’, [11] He conceived theory as providing a structure, a syntax, which could later be applied, that is, filled with meaning.

There is nothing in principle wrong with such abstraction provided that a link is made to the real world. The rate of acceleration, for example, was derived for objects falling in a vacuum. It is sufficient to observe a falling leaf or a flying squirrel to know that a modification must be made for the world of friction. If the link between theory and important features of reality cannot be made, the theory is devoid of application and has no relevance. The builders of analogue models have not bothered much with the transition between models embodying perfect (probabilistic) knowledge of the future and complete markets to the imperfect and uncertain world in which we live. The closest they get to ‘testing’ the model is to see whether it tracks aspects of the economy other than those it was designed to mimic.

Theory Construction: The Realist Approach
The alternative procedure is not to start with axioms (which in the case of economics are not at all self-evident anyway, as you will have noticed) but to base one’s theory on observations of reality. This is Keynes’s view of the matter in a letter to Roy Harrod: [12]

“Progress ... requires, as you say, ‘a vigilant observation of the actual working of our system.’ ... Economics is a science of thinking in terms of models joined to the art of choosing models which are relevant to the contemporary world. The object of a model is to segregate the semi-permanent or relatively constant factors from those which are transitory or fluctuating, so as to develop a logical way of thinking about the latter.

Good economists are scarce because the gift for using ‘vigilant observation’ to choose good models ... is a rare one.”

There is a problem with this approach too, for observation is mediated by theory: theory determines what you see, and disputes arise in economics partly because people see the world differently. But at least the transition from the model to correspondence with the real world is not so difficult. This was the procedure of Keynes and Schumpeter, for example. It is what I believe is good theory.

Macroeconomics: Relation to Microeconomics
When we turn to the question of the repercussions of the banking crisis and the response to it, we need macroeconomics, the study of the economy as a whole. When mainstream economists set out to do macroeconomics, they insist on starting from the same rational choice theory. This is called giving macroeconomics ‘microfoundations’. Anything not ‘microfounded’ is unacceptable to them. It is assumed that there is no problem of transition from individual behaviour to the system as a whole. This is only possible because the general equilibrium framework within which the mainstream operates pre-reconciles all plans before any actions are taken – an assumption made to ensure equilibrium, but which, like complete markets, would be beyond our computational powers – or because they have adopted the idea of the representative agent.

It was in order to pursue the aim of rigorous microfoundations that the representative agent was adopted by mainstream economists. [13] Everyone is the same. There are no differences from being on one side of industry or the other, no influence of one’s position in the life-cycle, and so on. They all make consumption, saving and investment decisions. There can be no ‘coordination failures’, no borrowing, for there is no one to borrow from, and no speculation, for the same reason. The macroeconomy cannot possibly exhibit the fallacy of composition.
In the real world, where individuals or groups act from their own interests and in partial ignorance of the larger picture, inferring the whole from knowledge of its parts risks committing the fallacy of composition. Avoidance of this fallacy through considering the economy as a whole constitutes the case for macroeconomics as a separate subject. Many mainstream economists deny the fallacy of composition and regard macroeconomics as having no right to a separate existence.

The fallacy of composition is at the heart of the current debate about government expenditure cuts. The government says that paying down its debts is just like paying off its credit card: it must cut its expenditure. The opposing argument looks at the repercussions on the rest of the economy: when incomes of government employees and revenues of their suppliers fall, those employees and suppliers will also cut back; the economy shrinks further, and tax revenue falls. The debt position could end up worse than before. You and I can pay off our debts by cutting expenditure, but the government is too big a player; the government’s argument commits the fallacy of composition.

The government’s rejoinder is that the private sector will fill the gap left by its cuts. This has its origin in two factors we have already seen: market clearing, so there is always full employment (the labour market clears) and that implies a constant aggregate income, and second, relative prices will alter to change the composition of output: when one sector shrinks, another expands.

When this compensatory action failed to materialise, the argument changed. Now we are told that the equilibrium we thought we were in before the crisis was illusory and we will have to come to terms with being poorer. Where does that leave the mainstream assumption that we are always in equilibrium?

Macroeconomics: Finance and Money
Returning to the question of the use of economics in understanding the financial crisis, it may – it ought – to shock you to know that the financial sector does not appear in most mainstream macro models. There are (at least) two reasons for this. First, except for international capital flows, one person’s debt is another’s asset, so, in aggregate, domestic debts/assets cancel out, and are dropped.

A second reason discouraging the inclusion of finance is the proposition that money, and by extension finance, is neutral in the long run: when the quantity of money changes, all that happens is that prices by the same proportion, leaving the real economy unaltered. This proposition has been around for quite a while: the earliest published source that I know of was published 30 years before the founding of the Bank of England. Money is understood only as a ‘veil’, slightly obscuring the workings of the real economy, or as something that ‘oils the wheels of industry’, an enabling factor that doesn’t affect ‘real’ decisions, despite the fact that some writers acknowledged that the real economy would be affected in the short run.

The neutrality of money pertains only to a long-run outcome in a monetary system based on precious-metal money or to monetary reforms such as fractional reserve or the introduction of the euro, where all assets are revalued at the same time. But it is the basis of much modern theorising. The economy is seen as in two separate parts, the real and the financial, with the latter only determining prices. It is called the Classical Dichotomy. You can see it in the brief given the European Central Bank, which has responsibility for inflation (or prices) and nothing else, or in inflation being the Bank of England’s prime (but not exclusive) target.

Good theory would acknowledge that, in a world where money is created as the counterpart to bank credit, the world in which we live, direction of credit matters, and the inflation of asset prices, including property, might have been seen as the danger signal it was.

Good Theory: Predicting this Crisis
There are many other problems with mainstream theory, but I think I have shown why it could not have predicted the financial crisis and its repercussions, and why I think it is bad theory.

Since the crisis broke there have been innumerable articles complaining of the inadequacies of mainstream economics. The mystery is why it persists in its present form. Lucas emphasised the importance of ‘testing’ models against the facts. And there are plenty of financial crises to provide a test-bed: an IMF working paper lists 124 systemic banking crises between 1970 and 2008. But in most mainstream models, there is no financial sector to test.

There is, however, some good theory, which did predict the crisis. Dirk Bezemer has looked closely at those who actually did predict the crisis, mainly looking at the situation in the USA, between 2000 and 2006, ‘well before most observers turned critical from late 2007’ (p. 8). He selected those who met his criteria: each had to have provided an account of how they reached their conclusion; have gone beyond a prediction of a housing crisis to the broader economy and provided an analytical link between them; have made their prediction in the public domain; and have attached some time horizon to their prediction. He then analysed the twelve contributions thus selected.

He found these common features: they all looked at debt or credit flows and the financial sector; they distinguished between real and financial wealth; and they knew the links between the real and financial sectors. Flows-of-funds accounts were an important source of their data.
These concerns not only acknowledge the interplay between the real and financial, precluded by the Classical Dichotomy. These analysts could see not only a housing bubble but how the financial bubble was created:

By accounting identity, any credit flows to firms and households (through banks’ credit creation as they lend) exceeding the growth of investment, production and consumption in the real economy will be held as wealth, and so invested in FIRE (finance, insurance and real estate) sector assets. This extra liquidity inflates the money value of financial assets and instruments (housing, stocks, bonds, currency, derivative instruments etc.), so increasing returns on financial investments. Through their rising net worth, firms and households can - if lending regulations allow - borrow more against their collateral; and if they believe this to be sustainable, they will. This means that banks create yet additional credit which is again invested in the FIRE sector, further pushing up asset prices. Each flow of credit has its balance sheet counterpart in increased debt levels for firms and households. (p. 17)

But it is only through real activity that debt is ultimately repaid, so this financial bubble was bound to burst too. And once the fragility of the banks was exposed, credit would dry up and the real economy would suffer.

That is indeed what happened. But these writers were not using conventional economic theory. Not even Keynes looked at the build-up of debt that is the counterpart of a long period of capital accumulation. Still less did he foresee the swelling of the financial sector that so unbalanced the ‘advanced’ economies before the crash. In his time, the financial sector was tightly regulated and was not able to escape its role of service to the real economy to become its master. The deregulation measures begun in 1971 permitted that.

Good Theory: A General Theory of Crisis
Shortly after the crisis broke, people were busy rediscovering Hyman Minsky, or at least a part of his work. He embodied the principle of ‘vigilant observation’ as he traced the development of ‘finance capitalism’. He died in 1996, before things really got out of hand. Although there was much talk of a ‘Minsky moment’, this trivialised both the severity of the crisis and the extent of his contribution. Minsky fully recognised the dual nature of banks: that they were structurally fragile but a great engine of growth. His Financial Instability Hypothesis proposes that crises come out of stability itself.[20] A period of stability leads to complacency and a search for higher returns, and because things look so solid, people take more risk; the crisis begins to brew. The economy progresses (if that is the right word) from safe ‘hedge finance’ where cash flow covers both interest and capital amortisation; to ‘speculative finance’, where cash only pays off interest; to Ponzi[21] finance, in which interest can only be covered by further borrowing. The debt becomes unsustainable.

This vision couldn’t be farther from The Great Moderation, a phrase popularised in 2004 by Ben Bernanke, now Chairman of the Board of Governors of the Federal Reserve System.[22] It was then believed that fluctuations in GDP had become more stable, or, in Gordon Brown’s phrase, we had abolished boom and bust. Minsky would say that is exactly when to worry.

These are just two examples of good theory producing useful analysis. Many economists are working in the realist vein, but they find it difficult to gain a hearing.

Bad Theory has Driven Out Good: Defence of the Belief System
Why were these warnings ignored? There are benign reasons and more sinister ones.

Amongst the benign is that no one wants to spoil the party. Think, again, of Gordon Brown at the Mansion House[23] in 2006, praising the banks for creating so much wealth, or the complacent Alan Greenspan, arguing that it was too difficult to prick a bubble; it was easier to clean up after it had burst (especially if you retire and leave that job to others).

But I hinted at the beginning that there were less benign forces at work. Mainstream economists are not tolerant of views that contradict their own. Since they began to gain power in the 1970s (they were not always the mainstream), they have done everything possible to defeat opposition: they now control the main academic journals, and it is nearly impossible to get a university appointment without publishing in these journals. The Research Assessment Exercise, now the Research Excellence Framework, assesses departments on the basis of publications in these journals.[24] Work published elsewhere is assumed to be second-rate.

Direct confrontation often results in the challenger being ridiculed or savaged. James Galbraith, son of John Kenneth, spoke of 250 economists giggling when he said (in 2000) that a federal budget surplus was a drag on the economy.[25] At the Federal Reserve Bank of Kansas City’s annual conference at Jackson Hole in 2005, Raghuram Rajan predicted the crisis. He said of his treatment, ‘I felt like an early Christian who had wandered into a convention of half-starved lions.’[26]

This is not a new phenomenon: although he couldn’t be ignored, Keynes seemed to attract animosity. Lauchlin Currie recalls[27] that in his days at Harvard (1925-34, even before The General Theory was published) a new book or article by Keynes was a target on which all converged. If one could make a valid criticism of Keynes, one’s own stock automatically rose.

The General Theory[28] was subverted, even by his close associates,[29] and Lionel Robbins mounted a campaign to counteract his influence, including bringing Friedrich Hayek to the LSE specifically for that purpose.[30]
The subversion went on until Keynes’s theory became Keynesian theory, a quite different animal, and now there is New Keynesianism, which is one of the two strands of the mainstream! The original Keynes is unrecognizable to the majority of economists, let alone the general public.

The open question in Keynes’s case is whether the objection was to his radical change of method, introducing true uncertainty about the future and challenging the market-clearing notion of equilibrium; to elements of his theory, such as his refusal of the Classical Dichotomy; or to its political implications: he concluded that the economy was not self-correcting; that the free market was flawed and needed intervention to function well; that monetary policy, particularly interest rate policy, favoured the financial sector rather than industry; that the direction of capital accumulation should not be left entirely in private hands.

These considerations undoubtedly still apply today.

Theory and Method
Those who have invested in learning one kind of economic theory will want to protect their investment. We know from Thomas Kuhn[31] that paradigms don’t change until the old guard die off.

More interesting than Kuhn’s proposition is why the young are attracted to this way of thinking. The mainstream of course control curricula and write the best-known textbooks, but even when given a choice, students often choose mainstream thinking - not all, as the Post-Autistic Economics movement in France and the students who recently walked out of Gregory Mankiw’s lectures at Harvard testify.[32] Cambridge students have just founded a Society for Economic Pluralism.[33] But mainstream economics does have a certain appeal: its models are precise and give demonstrable conclusions where an open approach such as that of Keynes requires knowledge of the economy and judgement over what to include. The younger you are, the less you trust your judgement, because judgement depends on experience.

A survey, famous among economists, of what students in the top US graduate schools thought was most important to being a successful economist, revealed the following ranking, starting with the most important:

1. Being good at problem solving.
2. Being excellent in mathematics.
3. Being very knowledgeable about one particular field.
4. Having the ability to make connections with prominent professors.
5. Being interested in, and being good at, empirical research.
6. Having a broad knowledge of the economics literature.
7. Having a thorough knowledge of the economy.[34]

Any hesitation that students might have felt about their knowledge and judgement is reinforced in those departments by the value system that is conveyed. We certainly can’t hope for much ‘vigilant observation of the actual working of our system’ from these students.

This ranking suggests something darker: their purpose is to get on as an economist, not to satisfy an innate curiosity about what makes the economy tick, and it is implicitly understood that economists are not valued for understanding the economy but for their technical sophistication, however empty it may be.

The formal, mathematical method has the additional appeal, to both existing practitioners and new entrants, of seeming to economists to be ‘scientific’: economics has long aspired to scientific status while misunderstanding the nature of science.

At a deeper level, the level of what Sheila Dow has called mode of thought,[35] there are also features which some find congenial, for example, mainstream economics derives from a dualistic mode of thought (‘is it A or not-A?’ - and it cannot be anything else: the law of the excluded middle). One can see it in the Classical Dichotomy, for instance. A dualistic mode of thought is most congenial to the young. Non-dualistic thinking requires a tolerance of ambiguity and ability to handle ‘grey areas’ (the excluded middle. These skills are normally learned, like judgement, as one matures, but some are always uncomfortable with them. I won’t go into detail on this,[36] because it takes us too far from our main theme, but it is important to make the further point that, to those who think dualistically, if they believe their theory is right, and you disagree with it, you can only be wrong. This gives mainstream opposition to alternatives its particularly sharp edge.

Ideology and Politics
I have to enter the tricky area of ideology. You know the problem: what you say is ideological, whereas my standpoint comes from pure conviction. But there is no doubt that mainstream economics, particularly the New Classical variant, supports the proposition that free markets lead to an optimal solution, and that free markets are regarded by some as desirable for their own sake. Someone once said that if mainstream economics did not exist, capitalism would insist that it be invented.

When neo-liberalism is in the saddle, the free-market conclusions of mainstream economics create the opportunity to give policy advice, which makes economists feel important and valued, sometimes to hold high-ranking policy posts, and to undertake lucrative consultancies. (I trust you have all seen the film Inside Job.) Heterodox economists may give evidence to the odd select committee, but it rarely goes further than that. The
message is clear: if you want to speak to power, make sure you say what power wants to hear, even if the correspondence of your theory to the real world is, to put it mildly, problematic.

Conclusion
In all these ways, bad theory has managed to drive out theory based on ‘vigilant observation of the actual working of our system’. What I have disobligingly called bad theory is the direct descendant of what Keynes called ‘Classical theory’. Of this theory he wrote:

The characteristics of the special case assumed by the classical theory happen not to be those of the economic society in which we actually live, with the result that its teaching is misleading and disastrous if we attempt to apply it to the facts of experience.[37]

So it has proved.

Economic theory has been used to change the world in its own image, with the connivance of governments that relaxed regulations to enable these changes. Business people took full advantage of the opportunities thus offered. The results include a financial system which proved fatally fragile and austerity policies which are not only personally and socially disagreeable but may also be self-defeating. Worst, in two countries so far, the crisis has undermined democracy.

This is not a private squabble amongst academic economists but a matter of profound public importance.

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See [http://www.guardian.co.uk/business/2006/jun/22/politics.economicpolicy](http://www.guardian.co.uk/business/2006/jun/22/politics.economicpolicy)


Sheila Dow gave its Inaugural Lecture two days ago. See [http://www.societies.cam.ac.uk/csep](http://www.societies.cam.ac.uk/csep/)


The General Theory, op. cit., p. 3.