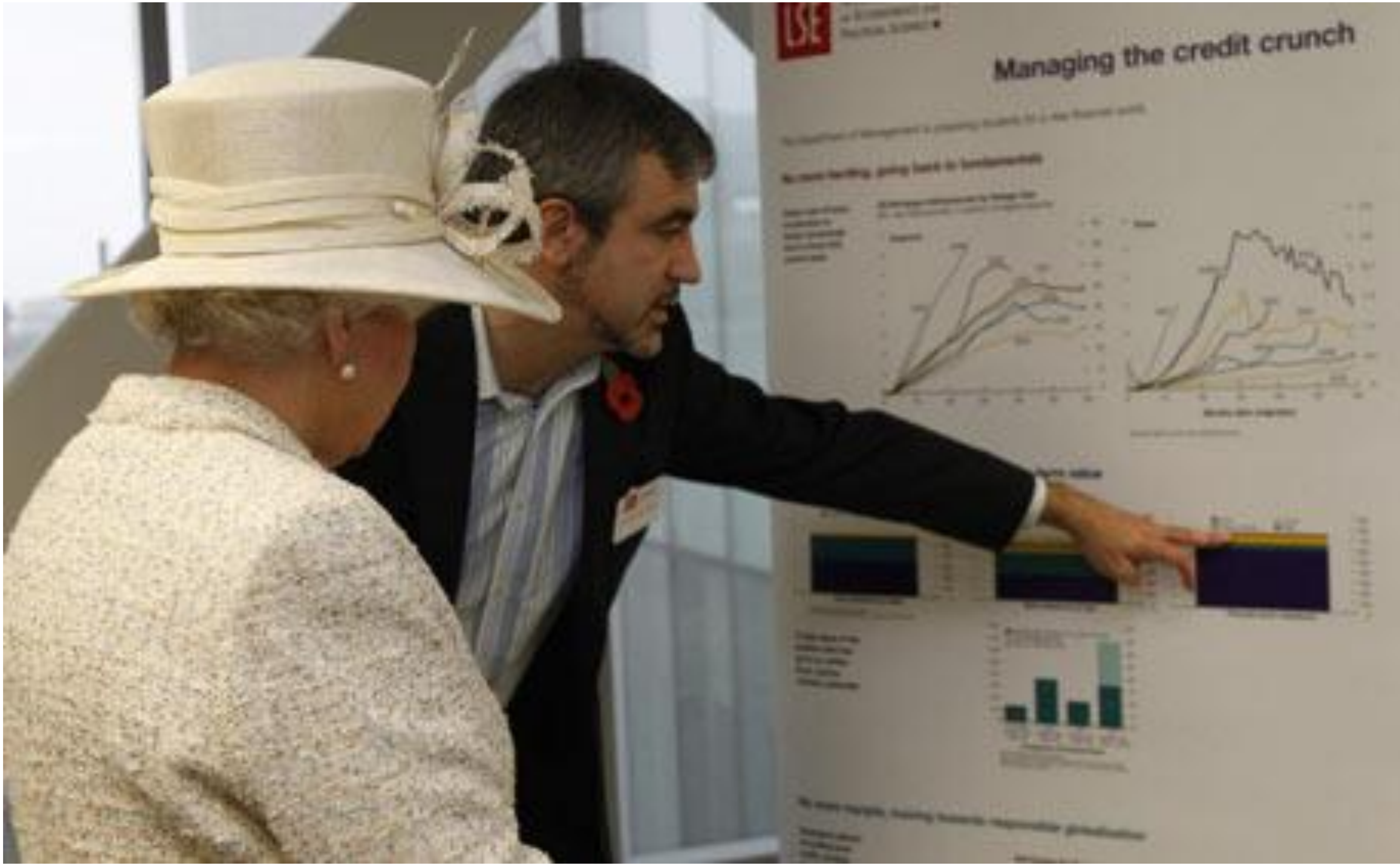
Gresham's Law in Economics? Background to the Crisis

Victoria Chick
University College London


LSE
Managing the credit crunch

Opening the New Academic Building at LSE, 5 Nov 2008

The Queen asked ‘Why did no-one see it coming?’

Professor Garicano is reported as replying that ‘At every stage, someone was relying on somebody else and everyone thought they were doing the right thing.’

Willem Buiter, founder member of the Monetary Policy Committee:

Mainstream macroeconomic theories 'not only did not allow questions about insolvency and illiquidity to be *answered*. They did not allow such questions to be *asked*.'

Basics of mainstream theory 1

Rational choice theory: maximise ‘utility’ according to preferences subject to a budget constraint.

Markets always clear (supply = demand). Called equilibrium

Basics of mainstream theory 2: financial assets

- Return (interest or dividends) v. risk
- Source of risk: future price changes (capital gains and losses)
- Modelled by fitting a probability distribution (bell curve) to past prices
- Preference for ‘risk aversion’

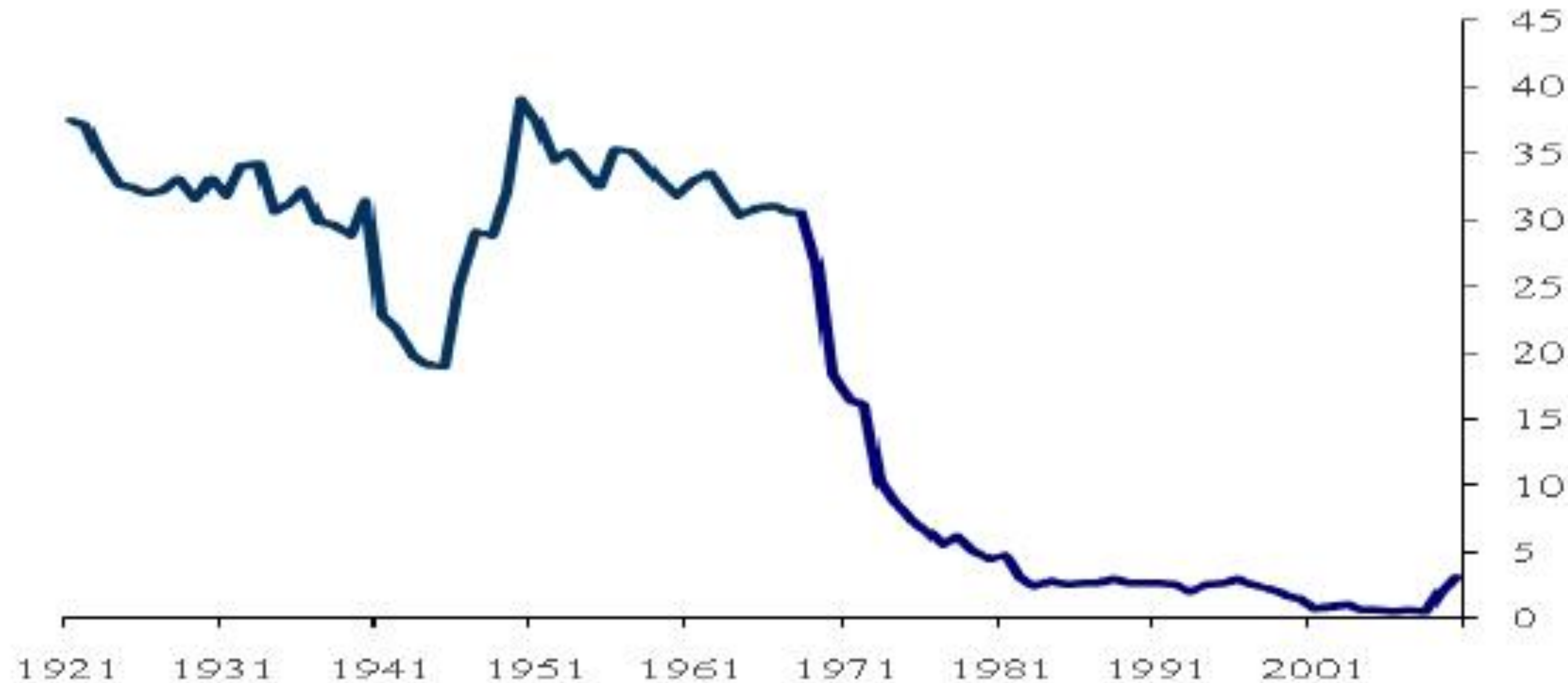
Efficient markets hypothesis

- Markets take full account of all publicly available information, including risk, in forming prices. Therefore they can be relied on to allocate capital efficiently, i.e. to the best uses.
- Implication: all assets are equally liquid.
- Departures from the ideal are called ‘market imperfections’, ‘rigidities’, ‘market failures’.

Complete markets

- There are markets catering for all possible future contingencies and outcomes, probabilistically.
- Contingent budget constraints, including borrowing, are also known. No one steals or fails to pay debts.
- Therefore, bankruptcy is impossible.

UK Banks Liquidity Ratio



Alan Greenspan, Chairman of the Federal Reserve System, 1987-2006:

‘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 …’

The story so far: Principles of mainstream economics

- 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.

The atomistic assumption

- No interaction between individuals except through ‘markets’. No interrelated preferences, e.g. keeping up with the Joneses.
- Therefore (they believe), no problem in aggregating individual choices to ‘market’ level.

Rational expectations

Rational expectations: after a period of learning, expectations of, say, future prices will not differ systematically from the equilibrium that the model predicts. Self-fulfilling, closed system.

Keynes in *A Treatise on Probability*:

‘[I]t is possible, under the cover of a careful formalism, to make statements which, if expressed in plain language, the mind would immediately repudiate.’

Constructing theories: two approaches

- All theories abstract from reality. Two ways:
- Idealist: start from ‘axioms’, deduce conclusions.
- Realist: start from an understanding of reality, identify the salient features and try to find causal connections.

Keynes, in a letter to Roy Harrod:

‘[P]rogress 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.’

Financial expansion

[C]redit flows to firms and households … exceeding the growth of investment, production and consumption in the real economy will be … invested in FIRE [finance, insurance and real estate] sector assets. This extra liquidity inflates the money value of financial assets and instruments… . [B]anks can create yet additional credit which is again invested in the FIRE sector, further pushing up asset prices.

Keynes in *A Treatise on Probability*:

‘[I]t is possible, under the cover of a careful formalism, to make statements which, if expressed in plain language, the mind would immediately repudiate.’

Constructing theories: two approaches

- All theories abstract from reality. Two ways:
- Idealist: start from ‘axioms’, deduce conclusions.
- Realist: start from an understanding of reality, identify the salient features and try to find causal connections.

J. R. (later Sir John) Hicks, Nobel Laureate

‘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.’

Idealist models: link with reality

- Must make a link with reality before application. Compare practice in physics, where results of an experiment carried out in a vacuum, say, are modified for the world of friction.
- Mainstream economists pay little attention to this problem of a link to reality, yet they give policy advice.

Keynes, in a letter to Roy Harrod:

‘[P]rogress 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.’

Mainstream macroeconomics

- Starts from the individual and rational choice theory
- Without such ‘microfoundations’, the theory is unacceptable.
- Unproblematic transition from individual behaviour to the economy is achieved by assuming a ‘representative agent’.

Fallacy of composition

- Inferring knowledge of the whole from knowledge of the parts or a part may entail the fallacy of composition (f/c).
- F/c the point of macroeconomics as a separate subject. Its importance is denied by the mainstream. (Obviously, with the use of the representative agent, it cannot exist.)

Finance and money

No financial sector in mainstream economic models.

- For a closed economy, debts and assets cancel out
- Neutrality of money, Classical Dichotomy

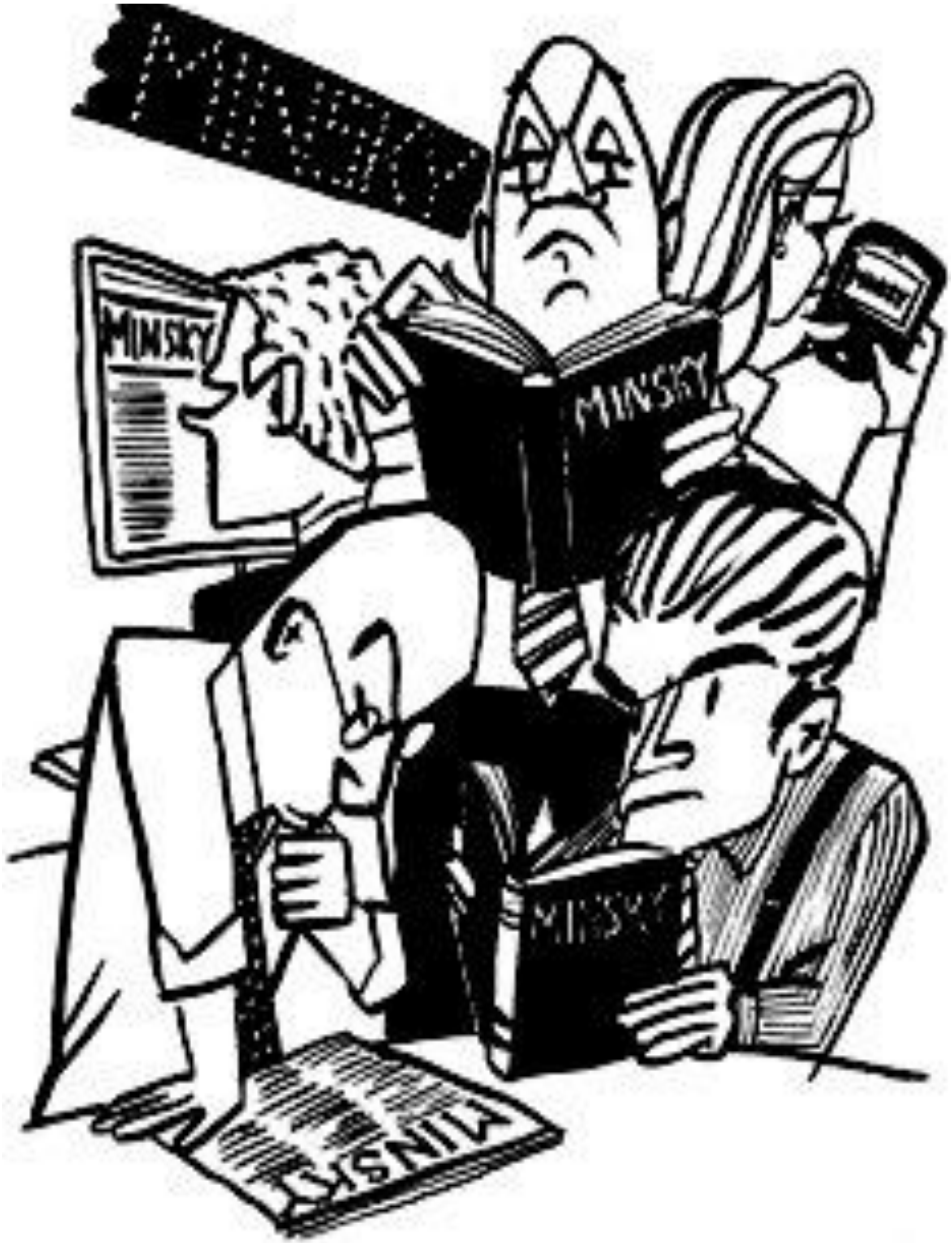
Those who predicted this crisis

- They 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

The financial bubble

[C]redit flows to firms and households … exceeding the growth of investment, production and consumption … will be … invested in FIRE [finance, insurance and real estate] sector assets. This extra liquidity inflates the money value of financial assets and instruments… . [F]irms and households can … borrow more against their collateral … . [B]anks create yet additional credit which is again invested in the FIRE sector, further pushing up asset prices.

more http://www.newyorker.com/talk/comment/2008/02/04/080204taco_talk_cassidy#ixzz1oMbGuGEr



Financial instability hypothesis

A period of stability leads to complacency and a search for higher returns, and because things look so solid, people take more risk.

Hedge finance

Speculative finance

Ponzi finance

Students in top US graduate schools: what makes a successful economist?

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.

Keynes, in *The General Theory*

‘[T]he 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.’