

# How a Decade of Crisis Changed Economics

If we want to change the economics profession, we need to start changing the world.

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Has economics changed since the crisis? As usual, the answer is: it depends. If we look at the macroeconomic theory of PhD programs and top journals, the answer is clearly, no. Macroeconomic theory remains the same self-contained, abstract art form that it has been for the past twenty-five years. As Joan Robinson once put it, economic theory is the art of pulling a rabbit out of a hat right after you've stuffed it into the hat in full view of the audience. The development of theory since the crisis has followed this mold. One prominent example: Immediately after the crash of 2008, Paul Krugman, writing in venues like the *New York Times*, announced that with interest rates at their zero lower bound, we had entered the Alice-in-Wonderland universe of the "liquidity trap" — a world in which the conclusions of orthodox economics are turned upside down and "perverse" Keynesian claims become true. Fiscal policy was now effective, printing money posed no danger of inflation, trade deficits really did cost jobs, and so on. He explicated these ideas using the "IS-LM" model found in undergraduate textbooks — a simple device that hasn't played a role in professional academic work in decades. Some years later, he and economist Gauti Eggertsson unveiled an elaborate mathematical New Keynesian model in the approved academic style, which showed that, indeed, if interest rates are fixed at zero, fiscal policy, normally powerless, becomes highly effective. This exercise may have been a display of technical skill. But what do we learn from it? The formal model was retrofitted to generate the argument that Krugman and others had already been making for years. I suppose what someone like Krugman might say in his defense is that he wanted to find out if the rabbit would fit in the hat. But if you do the math right, it always does. What's funnier in this case is that it turned out the rabbit actually *didn't* fit. As the conservative economist John Cochrane gleefully pointed out, Krugman and Eggertsson's math also implies that in a liquidity trap raising taxes on wages should boost employment — a bizarre policy conclusion that no one would accept. But since the authors didn't believe in such a conclusion before writing down the equations, they didn't believe it afterward either. As Eggertsson judiciously put it, "there may be reasons outside the model" to reject the idea of increasing payroll taxes. The kind of academic macroeconomic theory Krugman and Eggertsson were deploying is a strange beast indeed. The heart of it is the idea that the economy can be thought of as a single infinitely-lived individual calculating the trade-off between leisure and consumption over all future time. For an orthodox macroeconomist — anyone who hoped to be hired at a research university in the past thirty years — this approach isn't just one tool among others. It *is* macroeconomics. Every question

has to be expressed as finding the utility-maximizing path of consumption and production over all eternity, under a precisely defined set of constraints. Otherwise it doesn't scan. It might seem like an odd default, given the obvious fact that real economies contain households, businesses, governments, and other distinct entities, none of which can turn income in the far distant future into spending today. But it has the advantage of fitting real-life macroeconomic problems — which at face value would seem to involve uncertainty, conflicting interests, coordination failures — into the scarce-means-and-competing-ends, Robinson Crusoe-type vision that has long been economics' home ground.

At the same time, many producers of this kind of model actually have a quite realistic understanding of the behavior of real economies, often informed by firsthand experience in government. The combination of real insight and tight genre constraints leads to a strange style of theorizing, where the goal is to produce a model that satisfies the methodological conventions of the discipline while arriving at a conclusion that you've already reached by other means. It's the economic equivalent of the college president in Randall Jarrell's *Pictures from an Institution*:

About anything, anything at all, Dwight Robbins believed what Reason and Virtue and Tolerance and a Comprehensive Organic Synthesis of Values would have him believe. And about anything, anything at all, he believed what it was expedient for the president of Benton College to believe. You looked at the two beliefs, and lo! the two were one. Do you remember, as a child without much time, turning to the back of the arithmetic book, getting the answer to a problem, and then writing down the summary hypothetical operations by which the answer had been, so to speak, arrived at? It is the only method of problem-solving that always gives correct answers.

Columbia economist Michael Woodford, perhaps the leading theorist of "New Keynesian" macroeconomics, more or less admits that the purpose of his models is to justify the countercyclical interest rate policy already pursued by central banks, in a language acceptable to academic economists. Of course, the central bankers themselves don't learn anything from such an exercise — and you will scour the minutes of Fed meetings in vain for any learned discussion of "first-order ARIMA technology shocks" — but they presumably find it reassuring to hear that what they already believed is consistent with the most modern economic theory.

Left critics often imagine economics as an effort to understand reality that's gotten hopelessly confused, or as a systematic effort to uphold capitalist ideology. But both of these claims are, in a way, too kind — they assume that economic theory is "about" the real world in the first place. Better to think of it as a self-contained art form, whose apparent connections to economic phenomena are the results of a confusing overlap in vocabulary. Think about chess and medieval history: the statement that "queens are most effective when supported by strong bishops" might be reasonable in both domains, but its application in the one case will tell you nothing about its application in the other.