



Economics in Crisis

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The most interesting moment at a recent conference held in Bretton Woods, New Hampshire—site of the 1945 conference that created today’s global economic architecture—came when *Financial Times* columnist Martin Wolf quizzed former United States Treasury Secretary Larry Summers, President Barack Obama’s ex-assistant for economic policy. “[Doesn’t] what has happened in the past few years,” Wolf asked, “simply suggest that [academic] economists did not understand what was going on?”

Here is the most interesting part of Summers’ long answer: “There is a lot in [Walter]

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Bagehot that is about the crisis we just went through. There is more in [Hyman] Minsky, and perhaps more still in [Charles] Kindleberger.” That may sound obscure to a non-economist, but it was a devastating indictment.

Bagehot (1826-1877) was a mid-nineteenth-century editor of *The Economist* who published a book about financial markets, *Lombard Street*, in 1873. Summers is certainly right: there is an awful lot in *Lombard Street* that is about the crisis from which we are now recovering.

Minsky (1919-1996) is best approached not through his collected essays, entitled *Can “It” Happen Again?*, but rather through the use Kindleberger (1910-2003) made of his work in his 1978 book *Manias, Panics, and Crashes: A History of Financial Crises*. Asked to name where to turn to understand what was going

on in 2008, Summers cited three dead men, a book written 33 years ago, and another written the century before last.

Summers then enlarged his answer to include living economists: “[Eichengreen](#), [Akerlof](#), [Shiller](#), many, many others.” He talked about “the revolution in finance as it was realized that asset prices show large volatility that does not reflect anything about fundamentals,” but added that “macroeconomics [did not] keep up with [this] revolution.” As a result, “to the great detriment of contemporary macroeconomics,” his fellow economists did not understand asset prices, manias, panics, and liquidity.

For Summers, the problem is that there is so much that is “distracting, confusing, and problem-denying in...the first year course in most PhD programs.” As a result, even though “economics knows a fair amount,” it “has

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forgotten a fair amount that is relevant, and it has been distracted by an enormous amount.”

I think that Summers’ judgments are fair and correct. And I count myself among those who had forgotten and been distracted, even though I have always assigned *Lombard Street* to my economic history courses and *Manias, Panics, and Crashes* to my macroeconomics classes, and have always paid close and respectful attention to [Eichengreen](#), [Akerlof](#), and [Shiller](#).

But I was shocked by how large a panic was produced by what seemed to me—and still does—relatively small losses (in terms of the size of the global economy) in subprime mortgages; by the weakness of risk controls at the major highly-leveraged banks; by how deep the decline in demand was; by how ineffective the market’s equilibrium-restoring forces have been at rebalancing labor-market supply and demand; and by how much core-country governments have been able to borrow to support demand without triggering any run-up in interest rates.

It is the scale of the catastrophe that astonishes me. But what astonishes me even more is the apparent failure of academic economics to

take steps to prepare itself for the future. “We need to change our hiring patterns,” I expected to hear economics departments around the world say in the wake of the crisis.

The fact is that we need fewer efficient-markets theorists and more people who work on microstructure, limits to arbitrage, and cognitive biases. We need fewer equilibrium business-cycle theorists and more old-fashioned Keynesians and monetarists. We need more monetary historians and historians of economic thought and fewer model-builders. We need more [Eichengreens](#), [Shillers](#), [Akerlofs](#), [Reinharts](#), and [Rogoffs](#)—not to mention a Kindleberger, Minsky, or Bagehot.

Yet that is not what economics departments are saying nowadays.

Perhaps I am missing what is really going on. Perhaps economics departments are reorienting themselves after the Great Recession in a way similar to how they reoriented themselves in a monetarist direction after the inflation of the 1970’s. But if I am missing some big change that is taking place, I would like somebody to show it to me.

Perhaps academic economics departments will lose mindshare and influence to

others—from business schools and public-policy programs to political science, psychology, and sociology departments. As university chancellors and students demand relevance and utility, perhaps these colleagues will take over teaching how the economy works and leave academic economists in a rump discipline that merely teaches the theory of logical choice.

Or perhaps economics will remain a discipline that forgets most of what it once knew and allows itself to be continually distracted, confused, and in denial. If that were to happen, we would all be worse off.

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