

AN EDIT OF **Straight Talk On Trade**

08.35 __An-Edit-of__Straight-Talk-On-Trade_by_Dani-Rodrik__(31-Aug-2018)

by Dani Rodrik



Audible Chapter 6 – about 2.42

Nobel Confusion.

When the 2013 Nobel Prize in economics, was awarded to Eugene Fama and Robert Shiller along with Lars Peter Hansen, many were puzzled by this section. Fama and Shiller are both distinguished and highly regarded scholars, so it was not their qualifications that raised eyebrows, what seemed odd was that the committee had picked them together.

The two economists seemed to hold diametrically opposed views on how financial markets work. Fama the University of Chicago economist is the father of ‘the efficient market hypothesis,’ the theory that asset prices reflect all publicly available information with the implication that it is impossible to consistently beat the market. Shiller the Yale economist meanwhile spent much of his career demonstrating that financial markets work poorly, they overshoot, are subject to bubbles,

sustained rises in asset prices that can not be explained by fundamentals and are often driven by behavioural rather than rational forces.

Could both be right? Was the Nobel committee simply hedging its bets? We can't read the jury's mind, but its selection highlighted a central feature of economics and a key difference between it and the natural sciences. Economics deals with human behaviour which depends on social and institutional context, that content in turn is the creation of human behaviour, purposeful or not. This implies that propositions in economics are typically context-specific rather than universal.

The best and most useful economic theories are those that draw clear causal links from a specific set of contextual assumptions to predicted outcomes. So **financial markets behave sometimes like Fama's theory and sometimes like Shiller's.**

The value of their respective theories is that they discipline our understanding of what type of financial market behaviour to expect under specific conditions. Ideally, they also help us choose which model or theory we should apply in a particular conjuncture, although this happens rarely.

Aptly the third Nobel laureate Lars Peter Hansen was given his prize for devising statistical techniques to test whether markets behaved in a fully rational fashion.

Audible Chapter 6 – about 34.28

The Friedmanite perspective greatly underestimates the institutional prerequisite of markets.

Let the government simply enforce property rights and contracts and presto markets can work their magic. In fact,

the kind of markets that modern economies need are not self-creating, self-regulating, self-stabilising or self-legitimising, governments must invest in transport and communications networks, counteract asymmetric information, externalities and unequal bargaining power, moderate financial panics and recessions, and respond to popular demands for safety nets and social insurance.

Markets are the essence of market economy in the same sense that lemons are the essence of lemonade, pure lemon juice is barely drinkable, to make good lemonade you need to mix it with water and sugar. Of course, if you put too much water in the mix you ruin the lemonade, just as too much government meddling can make markets dysfunctional. The trick is not to discard the water and the sugar but to get the proportions right.

Economics unlike the natural sciences rarely yield cut and dried results, economics is really a tool kit with multiple models each a different stylised representation of some aspect of reality. The contextual nature of its reasoning means that there are as many concussions as potential real-world circumstances. **All economics propositions are ‘if then’ statements, one’s skill as an economic analyst depends on the ability to pick and choose the right model for the situation. Accordingly figuring out which remedy works best in a particular setting is a craft rather than a science.**

The Hedgehog and the Fox. (37:44)

Unfortunately, economists and other social scientists get virtually no training in how to choose among alternative models, neither is such an aptitude professionally rewarded. Developing new theory and empirical tests is regarded as science while the exercise of good judgement is clearly a craft.

The philosopher Isaiah Berlin famously distinguished between two styles of thinking which he identified with the hedgehog and the fox. The hedgehog is captivated by a single big idea which he applies unremittingly, the fox by contrast lacks a grand vision and holds many different views about the world, some of them even contradictory. We can always anticipate the hedgehogs take on a problem, just as we can predict that market fundamentalists will always prescribe freer market regardless of the nature of the economic problem. Foxes carry competing, possibly incompatible theories in their heads, they are not attached to a particular ideology and find it easier to think contextually. In the terminology of Daniel Drezner foxes are thought leaders while hedgehogs are the true public intellectuals. **Scholars who are able to, navigate from one explanatory framework to another as circumstances require are more likely to point us in the right direction.** The world needs fewer hedgehogs and more foxes.

New Excerpt

Consider other issues of the day, the widely held presumption that minimum wages are damaging to employment carries considerably less weight today because of mounting evidence showing mixed results. There are models under which minimum wages either do not reduce unemployment or increase it. Even in the case of Brexit where the weight of evidence and theory predicts adverse economic results, economists would have been well advised to emphasise their uncertainty over their confidence.

Perhaps economists tend to agree that certain assumptions are more prevalent in the real world, or maybe they think that one set of models works better on average than another, even so as scientists should they not adorn their endorsements

with the appropriate caveats? Shouldn't they worry that categorical statements ~~such as those before~~ may prove to be misleading in at least some settings? **The problem is that economists often confuse 'a model' for 'the model,' when that happens a consensus is certainly not something to cheer about. Two kinds of mischief may then follow, first, there are errors of omission, cases in which blind spots in the consensus prevent economists from being able to see troubles looming ahead. A prominent example was the failure of economists to grasp the dangerous confluence of circumstances that produced the global financial crisis. As I argued earlier the oversight was not due to a lack of models of bubbles, asymmetric information, distorted incentives or bank runs, it was due to the fact that such models were neglected in favour of models that stressed efficient markets.**

And there are the errors of commission, where cases in which economists fixation on one particular model of the world makes them complicit in the administration of policies whose failure could have been predicted ahead of time. Economists advocacy of neoliberal Washington consensus policies, and of financial globalization falls into this category. What happened in both cases is that economists overlooked serious second-best complications, such as learning externalities and weak institutions, which blunted the reforms and in some cases called them to backfire.

New Excerpt

“Economics, unlike the natural sciences rarely yields cut and dried results, economics is really a tool kit with multiple models, each a different stylised representation of some aspect of reality. The contextual nature of its reasoning means that there are as many concussions as potential real-world

circumstances. All economics propositions are 'if then' statements! One's skill as an economic analyst depends on the ability to pick and choose the right model for the situation. Accordingly figuring out which remedy works best in a particular setting is a craft rather than a science." (08:27)

One reaction I get when I say this is the following, how can economics be useful if you have a model for every possible outcome. Well, the world is complicated, and we understand it by simplifying it. A market behaves differently when there are many sellers than when there are a few, even when there are a few sellers the outcome outcomes differ depending on the nature of strategic interactions among them, when we add imperfect information, we get even more possibilities. The best we can do is to understand the structure of behaviour in each one of these cases, and then have an imperial method that helps us to apply the right model to the particular context we are interested in.

So we have 'one economics – many recipes' as the title of one of my books puts it. Unlike the natural sciences, economics advances not by newer models superseding old ones, but through a richer set of models that sheds ever brighter light at the variety of social experiences.

It is surprising therefore that very little research is devoted in economics to what might be called economic diagnostics. Figuring out which among multiple models actually applies in a particular real-world setting.

Economists understand well the theoretical and empirical predictions of say Fama's or Shiller's models, but they lack systematic tools to determine conclusively whether it is one or the other that best characterizes Wall Street today, or

mortgage markets in 2007 for example. When they engage the real world this leads them to render universal judgement rather than conditional, picking one model over the other instead of navigating among them as the circumstances require.

The profession places a large premium on developing new models that shed light on an as yet unexplained phenomenon, but there seems little incentive for research that informs how appropriate models and remedies can be selected in specific contexts.

My colleagues and I have brought such ideas to bear on problems of growth policy in developing countries, but clearly, this ought to be part of a much more general research agenda. Over time of course good economists develop a knack for performing the needed diagnostics, even then the work is done instinctively and rarely becomes (cartified?) or expounded at any length. **Unfortunately, empirical evidence in economics is really reliable enough to settle decisively a controversy characterized by deeply divided opinion, certainly not in real-time.**

This is particularly true in macroeconomics where the time series data are open to diverse interpretations. Those with strong priors in favour of financial market efficiency such as Eugene Fama for example can continue to absolve financial markets from culpability for the crisis, laying the blame elsewhere. Keynesians and classical economists can continue to disagree on the interpretation of high unemployment. But even in microeconomics where it is sometimes possible to generate precise empirical estimates using randomised controlled trials, those estimates apply only locally to a particular setting. The results must be extrapolated using judgement and a lot of hand waving in order to be applied more generally. New economic evidence serves at best to

'nudge' the views, a little here, a little there of those inclined to be open-minded. One thing that experts know and that non-experts do not, the development economist Kaushik Basu has said, 'is that they know less than non-experts think they do.'

Paul Krugman a Nobel laureate who also writes a newspaper column has made a habit of slamming the latest generation of models in macroeconomics for neglecting old-fashioned Keynesian truth. **Paul Romer, one of the originators of new growth theory** has accused some leading names including the Nobel laureate Robert Lucas of what he calls mathiness, using math to obfuscate rather than clarify. **Richard H. Thaler a distinguished behavioral economist** at the University of Chicago has taken the profession to task for ignoring real-world behaviour in favour of models that assume people are rational optimizers. And finance professor Luigi Zingales also at the University of Chicago has charged that his fellow finance specialists have led society astray by overstating the benefits produced by the financial industry.

This kind of critical examination by the disciplines big names is healthy and welcome especially in a field that is often lacked much self-reflection. But there is a disconcerting undertone to this new round of criticism that needs to be made explicit and rejected. **Economics is not the kind of science in which there could ever be one true model that works best in all contexts (M-Theory Point). The point is not to reach a consensus about which model is right as Romer puts it, but to figure out which model applies best in a given setting and doing that will always remain a craft or art in Keynes terms, not a science especially when the choice must be made in real-time.**

In order to change the world, we need to understand it and this mode of analysis seemed to transport us to a higher level of understanding of economic and political outcomes. But there was a

deep paradox in all of this, the more we claimed to be explaining the less room was left for improving matters.

5.37

Audible Chapter 9 – 11:40

China

Starting in the late 1970's it made use of policy innovations such as two-track pricing, and special economic zones that effectively de-linked market-oriented incentives from their usual distributive implications.

Audible Chapter 9 – 37.55

Daron Acemoglu and James Robinson argue that economic analysis needs to identify, theoretically and empirically, conditions under which politics and economics run into conflict and then evaluate policy proposals taking this conflict and the potential backlashes it creates into account.

Goes on to say that Daron Acemoglu, James Robinson were not correct in some details...

Audible Chapter 12 – 45.18 – The Bricks

Skill and capital-intensive technologies are the leading culprits behind the rise in inequality since the late 1970s. By all indications this trend is likely to continue, it will produce levels of inequality that are historically unprecedented threatening severe social and political conflict.

It doesn't have to be this way!

With some creative thinking and institutional engineering, we can save capitalism from itself, once again. The key is to recognize that disruptive new technologies produce large social gains and private losses simulations. These gains and losses can be repackaged in a manner that benefits everyone. Just as with

the earlier reinvention in capitalism there is a large role for the state here.