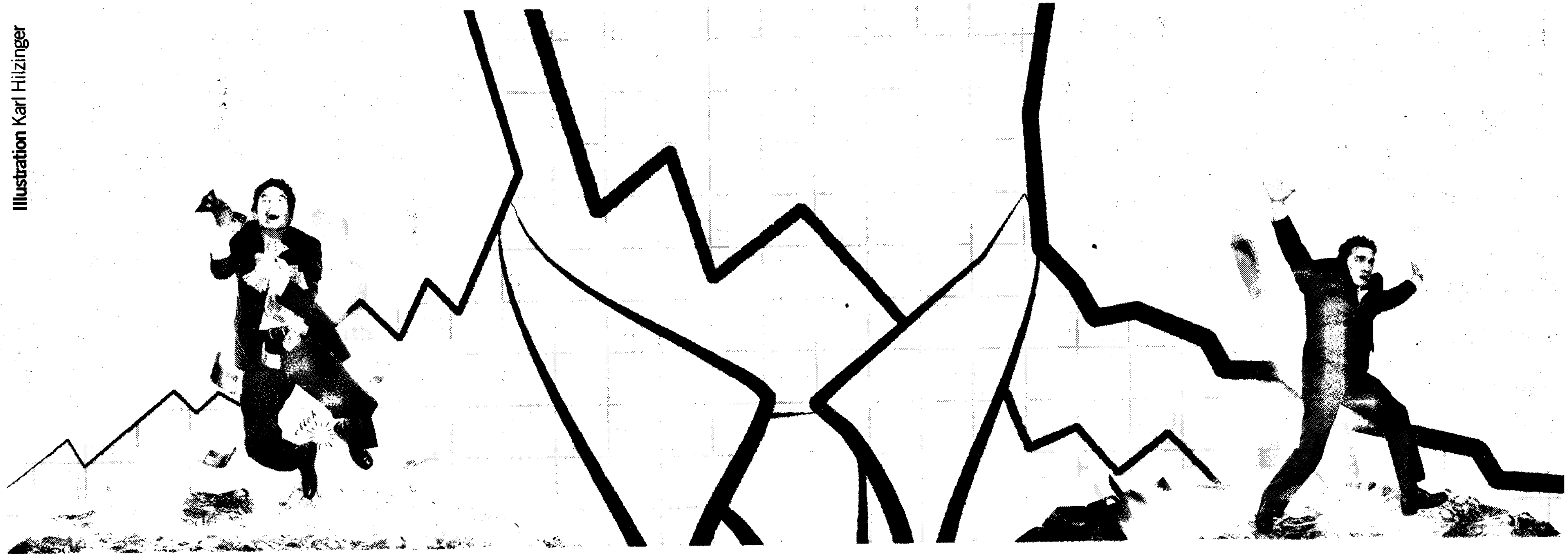
Illustration Karl Hilzinger



Old economics under fire

Much fundamental macroeconomic theory is now contested as it failed to anticipate or explain the current crisis.

Story Emma Connors

It sounded a little like heresy. In the pleasant surrounds of the Reserve Bank's

Grauwe. "A science that starts from the assumption that individuals have severe cognitive limitations; that they do not understand much about the complexities of the world in which they live.

"This lack of understanding creates biased beliefs and collective movements of euphoria when agents underestimate risk, followed by collective depression, in which perceptions of risk are dramatically increased. These collective movements turn

reasonable when every mortgage was a 30-year, fixed-rate loan. Now, they say, it's preposterous.

Sunstein's views and those of many like him have big implications for all those who oversee and take part in markets.

Traditional theory, for example, says a drop in real wages is necessary to address unemployment. Not so, say behaviourists, who believe real wages and working conditions can influence workers' effort levels

them and prosper, we must pay attention to the thought patterns that animate people's ideas and feelings, their animal spirits," the authors write.

All of this is a long way from the super-rational "homo economics", whom the executive director of the Australian Treasury's macro-economic group, David Gruen, vividly brought to life in a speech last month.

Since the 1970s, Gruen pointed out, macro-economists have

challenging the orthodoxy are judged to be making a useful contribution, even by those who don't agree with them.

Warwick McKibbin does not believe the financial crisis has substantially strengthened the case of behavioural economists but, in his role as head of the ANU macro-economics centre, he does believe in encouraging alternative schools of thought.

"The financial crisis was not a result of a failure of a model of

Story Emma Connors

It sounded a little like heresy. In the pleasant surrounds of the Reserve Bank's H. C. Coombs Centre for Financial Studies in Kirribilli last month, a European economist boldly questioned assumptions his peers around the world hold dear.

Paul de Grauwe, a professor of international economics at the University of Leuven, Belgium, told his audience mainstream economic models were deeply flawed.

"I find it surprising that central banks populated with rational men have thought using these models would keep the economy stable . . . It's clear this view has failed in the last 10 years," he told the behavioural economics conference at the centre, hosted by the Australian National University's Centre for Applied Macro-economic Analysis.

De Grauwe was speaking to a room full of academics all only too aware of how the global financial crisis has undermined conventional economic orthodoxies.

Writing this past week in the *Financial Times*, he elaborated, saying macro-economists were blinded by the idea that efficient markets would take care of themselves and assumed that people (economic agents) were superbly informed and understood the world's deep complexities; that people have rational expectations.

"Since they (rational economic agents) all understand the same truth, they all act in the same way. Thus modelling the behaviour of just one agent (a representative consumer and a representative producer) is all one has to do to fully describe the intricacies of the world.

"Rarely has such a ludicrous idea been taken so seriously by so many academics."

It is another "major flaw" that financial markets and the banking sector are left out of models.

"We need a new science of macro-economics," says de Grauwe. Behavioural economists believe individual misperceptions creates biased beliefs and collective movements of euphoria when agents underestimate risk, followed by collective depression, in which perceptions of risk are dramatically increased. These collective movements turn uncorrelated risks into highly correlated ones.

"What Keynes called 'animal spirits' are fundamental forces driving macro-economic fluctuations."

The new science de Grauwe advocates is behavioural economics, whose central tenet is that people are far from rational.

This is no longer merely an interesting discussion by learned people. Influential policymakers all the way to the office of the US President are convinced some thought must be given to the way people really act – as opposed to how economists have assumed they will.

Suddenly animal spirits are all the rage in the dismal science. The credit crunch and subsequent global recession have given huge support to those arguing the models used by neoclassical economists – who dominate the breed – need to be modified.

Left to our own devices, argue proponents of behavioural economics, we will often make mistakes, so sometimes we need a nudge – in the form of government regulation – in the right direction. We need economic policy that takes into account psychology.

It's an idea that's garnered a lot of attention, particularly in the US, where Cass Sunstein, who co-wrote *Nudge: Improving Decisions About Health, Wealth and Happiness*, is known as President Barack Obama's regulatory tsar.

Sunstein and *Nudge* co-author Richard Thaler say it's time to replace the the robot-like creatures who populate standard economic theories with real human beings.

They point out that a standard analysis of the mortgage market assumes borrowers are capable of choosing the best mortgage for their financial circumstances.

This assumption may have been

Traditional theory, for example, says a drop in real wages is necessary to address unemployment. Not so, say behaviourists, who believe real wages and working conditions can influence workers' effort levels and, consequently, productivity and innovation.

This movement hardly sprang out of nowhere. Indeed, economic literature all the way back to and including Adam Smith, the original champion of free markets, is studded with musings on the impact flawed thinking has on economic decisions.

But the global recession has thrown into sharp relief the arguments of those who believe

whom the executive director of the Australian Treasury's macro-economic group, David Gruen, vividly brought to life in a speech last month.

Since the 1970s, Gruen pointed out, macro-economists have believed their views on big policy issues should be grounded in the study of individual behaviour.

"The problem comes when we discover how individual behaviour is to be understood," Gruen said. "The individuals who populate this theoretical world have characteristics most of us might find a little quaint, to say the least. These individuals are assumed to be far-sighted and rational, and to understand, in extraordinary detail,

The problem comes when we discover how individual behaviour is to be understood.
David Gruen

the fallibility of humans and their resulting actions – which should be observed, as opposed to assumed – needs to be the starting point for thinking about economic decisions.

Sure, the free market models that have been revered for more than 300 years have done a reasonable job for most of the time. But what about when it all goes horribly wrong?

In the recently published *Animal Spirits*, US economists George Akerlof and Robert Shiller say the recent crisis was caused by individuals and their changing levels of "confidence, temptations, envy, resentment, illusions and other such intangibles".

It was these factors, they say, that prompted Americans to pay small fortunes for houses in cornfields, led others to finance such purchases, and drove the Dow Jones to a peak of more than 14,000 points and then crash to less than 7500 barely a year later.

"To understand how economies work and how we can manage

the economic world in which they live and make decisions."

Relying on the actions of such super beings meant many commentators failed to see the most recent crisis in the making, Gruen suggested.

"It is as if, as the Titanic was sailing into iceberg-infested waters, those with the requisite skills and training to warn of the impending danger were instead hard at work, in a windowless cabin, perfecting the design of ship hulls . . . for a world without icebergs."

Gruen added that Australian regulators were never convinced, as so many international regulators appeared to be, that individuals and companies in financial markets knew exactly what they were doing and had a complete understanding of the economic environment – so could safely be left to their own devices.

Here, where policymakers have so far managed to steer us clear of a technical recession, those

case of behavioural economists but, in his role as head of the ANU macro-economics centre, he does believe in encouraging alternative schools of thought.

"The financial crisis was not a result of a failure of a model of economics," McKibbin says.

"It was a combination of very poor regulation, a lack of information and poor responses of policymakers.

"A lot of people coming out of the woodwork at the moment have some interesting arguments but, in the end, it is an empirical question: If we model humans as irrational, crazy people and we add them all up in a market or in the world, do you end up with something that is very different from what we currently have?" he asks.

While McKibbin maintains "it is not clear economics as we currently have it is that far away from being the right way to think about these things", he is tolerant of those who suggest otherwise.

"There is a mainstream view on how people behave and then there are alternative theories, some of which are based on psychology, some of which are based on experimentation and designs of different systems.

"And it is very useful to keep encouraging that sort of work."

West Australian Ombudsman Chris Field has watched with interest as behavioural arguments have migrated from the corridors of academia into the heads of decision makers.

He thinks many of the insights provided by the discipline are useful, but believes they should be handled with caution by regulators who are, presumably, as fallible as everyone else.

"A reasonable criticism of behavioural economics is that it doesn't place quite enough on the value of the personal freedom and liberty that [we enjoy in] the free and prosperous society we live in," Field says.

"We have to exercise some caution in telling people how to live their life, even though we may disagree with it."

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