The Economic Crisis in Retrospect
Explanations by Great Economists

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1. Insights for today’s trying economic times

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These are surely trying economic times. True, modern economies have continued to push back the boundaries of scarcity. Real incomes in virtually every country of the world have risen strongly over the past decades – giving us standards of living that our grandparents, great-grandparents and more distant ancestors could only dream about (Maddison, 2001). But, the domestic and international economies have been rattled by recent events. In the wake of the 2008 financial crisis, the median net worth of American households fell from $126,400 (2007) to $77,300 (2010) – wiping out nearly two decades of growth (Bricker et al., 2012). For the first time since the Great Depression, the US unemployment rate stubbornly remained above 8 percent for over four years. In August 2011, Standard and Poor’s downgraded the credit rating of the federal government from AAA to AA+ – and the fiscal condition of the US government looks increasingly cloudy due to projections of high budget deficits and climbing debt into the foreseeable future. The American
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economy is gripped with uncertainty and accordingly investment’s share of GDP remains at an historic low while non-financial businesses sit on a stockpile of over a trillion dollars in cash, waiting to decide what to do with these funds (Fox, 2012).

In meeting these current and future challenges politicians, policymakers, and academicians have naturally sought the wisdom of eminent economists of the past and turned to the lessons of history. Although applying the insights of men like Walter Bagehot, Thorstein Veblen, John Maynard Keynes, Joseph Schumpeter, Friedrich Hayek, and Milton Friedman to today’s trying times risks asking questions that dead men are ill-equipped to answer, putting words into their mouths, and projecting our own opinions disguised in their authoritative mantles, the contributors to this volume all believe that this is a useful exercise; we can gain crucial insights for today and tomorrow from great economists of yesterday. Although they recognize that the historical record is often murky, our contributors agree that we can learn a lot from history.

This volume combines recent public addresses by five eminent historians of economic thought, an economic historian and a Nobel Prize winning economic theorist schooled in the importance of understanding history. Their talks were given at Wake Forest University (Winston-Salem, NC, USA) during 2011–12 as part of a series sponsored by the university’s BB&T Center for the Study of Capitalism. Each of these economists was given simple marching orders – explain to beginning economics students what insights can be gained from your own research on today’s economy in light of your study of the life and works of historically important economists and economic history. The Insights from Great Economists of the Past series sought a rough ideological balance, and because today’s economy is so fundamentally different from the economy of the distant past we focused mainly on twentieth-century economists and the twentieth-century experience – neglecting important voices like Adam Smith, David Ricardo, and Karl Marx. The four twentieth-century economists we chose are among that century’s most influential. The economists surveyed by Davis et al. (2011) were asked to identify their favorite deceased twentieth-century economists and chose John Maynard Keynes, Milton Friedman, Paul Samuelson, Friedrich Hayek, Joseph Schumpeter, John Galbraith, and Thorstein Veblen as their top seven. We have turned to four of them – Keynes, Hayek, Schumpeter, and Veblen – for insights, along with nineteenth-century economist Walter Bagehot, a man known for virtually ‘writing the rules’ about how central banks should handle financial crises.

Following this introduction, these influential economists are presented in the chapters in chronological order of their lives, beginning with Bagehot. Because the twentieth-century economists had the ‘advantage’ of experiencing the Great Depression during the 1930s, which was
reflected in their writings, we have also included a talk given by Peter Temin on this unique period of economic history. Finally, because this volume begins with Bagehot and the role of central banks, we conclude with a talk given by Thomas Sargent (2011 Nobel Prize in Economic Sciences) on shifting lines in historical debates about monetary (and fiscal) policy and contemporary thinking about the role of central banks. Fittingly, Milton Friedman is the leading character in Sargent’s drama and his research on monetary history lurks in the background in Temin’s analysis of the Depression, who also draws important insights from Keynes.

It is not just policymakers and academics who have turned to the wisdom of these thinkers. The broad public is eager to learn from them as well, perhaps best exemplified by the fact that the entertaining video “Fear the Boom and Bust” a Hayek vs. Keynes Rap Anthem’ has attracted over four million YouTube views – with its sequel, ‘Fight of the Century: Keynes vs. Hayek Round Two’ receiving over two million. Both Hayek and Keynes have been mentioned in the popular business press (e.g. Wall Street Journal, The Economist) over 10,000 times in the last two years. Though gone, these economists and their ideas are very much a part of the current conversations. While videos and media mentions are certainly useful and engaging, our authors paint a more sober, nuanced picture of their protagonists, whose legacies have often overshadowed what they actually said, wrote, and believed.

Although we have read most of the classic texts by this quintet – books like Keynes’s General Theory, Hayek’s Road to Serfdom, Schumpeter’s Capitalism, Socialism and Democracy, Veblen’s Theory of the Leisure Class, and Bagehot’s Lombard Street – we co-editors (an economist and a business academic) are not historians of economic thought, having neither researched nor taught in the field. Consequently, along with our students we learned a lot from the Insights series.

In the first chapter following this introduction, Perry Mehring reflects on Walter Bagehot’s view of the central banking system. Just as the central bank concept was evolving during Bagehot’s time, so too does it continue to evolve today. Because of this evolution, we do not fully understand the system, the triggers to the system, or its consequences. Robert Prasch picks up a similar argument in his Chapter 3 discussion of Thorstein Veblen, who focused extensively on how institutions affect economic and financial behavior.

Keynes makes his first appearance in Bradley Bateman’s Chapter 4. Bateman claims that the contemporary question of whether the government is spending too much or too little to spark the economy is not the question Keynes would have been interested in answering. Like Peter Temin’s Chapter 5 on the Great Depression, economic booms and busts often arise from booms and busts in expectations and thus capital investment. While Bateman focuses on Keynes’s interest in fiscal
policy, Temin discusses the appropriate balance between fiscal and monetary policy.

The Austrians make their appearance in the next two chapters. Richard Langlois provides a précis of Schumpeter’s life and intellectual contributions in Chapter 6. Although Schumpeter harbored a profoundly modern view of the role of entrepreneurship in economic growth, he was less sanguine about ways in which the financial system could be managed to achieve growth and stability. In Chapter 7 Bruce Caldwell describes Hayek’s well-known view about government interference in the economy, and points out that because innovation continues to occur (including financial innovation) authorities cannot know precisely how things actually work now and are always regulating for the last crisis.

Thomas Sargent provides a thoughtful conclusion to this series of talks in Chapter 8. Touching on several ideas mentioned in the preceding chapters, Sargent wonders about equilibrium(s) in a dynamic economy and the uncertainties that surround causes, policies and potential consequences.

We highlight several themes from this collection of talks that interestingly seem to transcend the varying perspectives. The first theme is that these economists recognized that the bringer of growth – the capitalist economic system – is a dynamic system. The prevalence of uncertainty and imperfect information, the role of differing ex ante expectations among human actors, and the ubiquity of inter-temporal choice ensure that ‘general equilibrium’ remains a largely theoretical construct (Boettke, 2012). Because of this and in combination with government involvement in the economy, business cycles and occasional financial crises are virtually inevitable. We do not know what is coming next. Old rules and ways of doing things need to be constantly updated. This is how Richard Langlois summarizes the master expositor of this change, Joseph Schumpeter: ‘Capitalism . . . is by nature a form or method of economic change and not only never is but never can be stationary. . . . Here is [Schumpeter’s] 1,000 page book [Business Cycles] in three bullet points. Point one: Entrepreneurial innovation creates a disequilibrium as resources move from old less-valued uses to new more-valued uses. Point two: This disequilibrium is the business cycle. Point three: Entrepreneurial innovations . . . appear in correlated “swarms”.

The dynamism of this system also helps explain one of Thomas Sargent’s key points – the best public policy rules are not always clear. Uncertainties about which economic theory best fits people at a particular place and time have led to a lot of ‘close calls’ about what set of institutions will work best – and have caused intelligent analysts from James Madison to Milton Friedman to sometimes flip-flop on major policy issues. Peter Temin is especially cautionary about the dangers of ignoring this economic dynamism, blaming misplaced ‘nostalgia’ that ignored economic changes as a cause of both the Great
Depression and the recession of 2008. In the aftermath of World War I, this misplaced nostalgia led to a resurrection of the gold standard, a system that had become dysfunctional due to recent economic changes. Adherence to this broken system threw the world into depression. He warns that we are in danger of repeating these mistakes with modern fixed-exchange rate regimes, including the adoption of the euro and China pegging its renminbi rate to the dollar.

The second and related theme is that markets and economic evolution are extremely complex. Policymakers, and especially we economists, need to show a lot of humility because we do not and essentially cannot understand what is happening most of the time. This is how Bruce Caldwell summarizes the chief proponent of this insight, Friedrich Hayek: ‘Many economic phenomena are in fact examples of complex phenomena, for which we have limited ability to make predictions other than what [Hayek] called pattern predictions. So he wrote a lot about the limitations of knowledge … [and] emphasized [that] this knowledge problem is a huge obstacle to rational policymaking.’ Hayek worried about the hubris of policymakers during and after the depression and war years; something it is not difficult to find today in the halls of government. According to Brad Bateman, Hayek’s ‘rival’ Keynes exemplified a similar humility: ‘Keynes never said that the government could exactly hit some economic target’; instead he emphasized that it is hard to understand what causes changes in the expectations of key business decision makers, in their ‘animal spirits’, and we should not act as if they and the economy as a whole are easy to predict. In Bateman’s understanding, Keynes gave up the ‘magic formula’ way of thinking about policies as his ideas matured. All these thinkers understood that uncertainty is everywhere in the economy and inevitable. This need for humility and inability to predict what will happen next in a complex economy is exemplified in a recent advertisement by Ally Bank. In a sober-looking lecture hall, the host begins: ‘Tonight our guest: Thomas Sargent, Nobel-Laureate in economics and one of the most cited economists in the world. Professor Sargent, can you tell me what CD rates will be in two years?’ Sargent’s one-word response: ‘No.’

A third big insight is that economists need to be more sociological, psychological, and anthropological in understanding economic behavior. Human beings are, after all, human beings – and economists ignore this complexity and humanity at their peril. Veblen stressed this point the hardest, emphasizing how things like ‘laws, business practices, and habits of thought, and … norms get built into our economic system’, and how modern economics takes a dangerous shortcut when it assumes that people are somehow just given or endowed with preferences.

The fourth insight is that in this complex, hard-to-understand world people make mistakes – sometimes big mistakes. The invisible hand also
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has unintended consequences! We are sometimes prisoners of out-of-date or ill-designed institutions, and occasionally subject to bad judgment. This is one of Peter Temin’s key points in explaining the root causes of the Great Depression. The lesson, then, is that policy should not encourage even more mistakes and an important way to avoid big mistakes is to carefully examine history, institutions and the economic system. Perry Mehrling turns to the past for this very reason: ‘I’m inspired by Bagehot because he looks at history to try to distill wisdom from the pragmatic, practical experience of practical bankers. He looks at institutions and asks, “How do these markets actually work?”’, and only then does he offer advice on how to make the system work better.

The last insight, as Peter Temin pithily puts it, is that ‘memories fade’ – so we need to periodically remind ourselves about important historical events and processes and about the lessons that astute economists of the past taught.

Dynamism, complexity, humility, humanity, fallibility, and forgetfulness – it is hard to capture this in meaningful, useful economic theories and models. Boettke (2012), in fact, argues that the focus on macro-economic phenomena in combination with positivist research in economics has deepened economists’ detachment from these facets of economic behavior. This does not mean that modern economic theories are useless. Bruce Caldwell seconds Hayek’s argument that the most useful economic theories are the standard tools students learn in Introduction to Economics courses – models that have stood the test of time and are easy to use, models that generally use only simple geometry and algebra. In his chapter at the conclusion of this volume Sargent also extols the value of simplicity leading to strong reasoning. The great economists of the past – especially those represented here – did not need the complex mathematical models seen in the pages of modern economics journals to gain deep insights into the economy.

For these reasons we suggest that the papers in this volume present excellent material for economics and business students. Many of these students become leaders in business and society many years after they have completed their studies. Beyond the technical training they receive in their respective disciplines, it is important for future leaders to appreciate the deeper insights gained from reading the great economists. Such insights can only serve to create a new generation of balanced, thoughtful leaders who seek to apply the lessons of the past to emergent new economic phenomena.

References


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2. Insights from Walter Bagehot

**Perry Mehrling**


I have been teaching money and banking at Barnard College at Columbia University for 15 years and a lot of my students actually work in the money markets, or down at Goldman Sachs, or somewhere like that. When I first started teaching it, I found that there was a big disconnect between the lives the students were experiencing and what was in the textbooks. So eventually I got rid of the