Comment

Ten practical principles

- *Much of the contemporary economic policy debate is unsubtle and unedifying*
- *The global crisis did little to forge a credible new consensus among economists*
- *Rather, it has left them seriously split, on both interpretation and prognosis*
- *Never a pure science, economic policy settings should not be determined by dogma*
- *Recent history offers important lessons and guidelines for future action*

Note: Russell Jones originally delivered the essence of this *Comment* as a talk; we are taking this opportunity to put it before our clients also.

Damaging delusions

The pre-crisis conventional wisdom was found wanting …

In low moments I almost despair of my profession; and certainly the pitifully lowbrow and prejudiced economic debate during the UK election campaign was far from edifying. No wonder economists and economic policymakers are so often disparaged.

Going into the global financial crisis, the conventional wisdom was that central banks were omnipotent, light-touch regulation was the way to go, the business cycle had largely been tamed, and the sort of cataclysmic event that was about to unfold was nigh on impossible.

Coming out of the crisis, the majority view was that monetary policy was still the most potent tool with which to manage the economy, the brief flirtation with fiscal expansion in 2009 and 2010 should be rapidly reversed and would in any case be relatively painless, and, as long as governments were not too heavy-handed in their interventions, the 'confidence fairy' would soon ensure a rapid recovery. Things, in short, would soon be back more or less in line with the *status quo ante*.

… and economists are now divided along tribal lines …

All this proved to be wishful thinking. Yet no new consensus about how modern economies work and how they should be managed has emerged. Indeed, economists are hopelessly divided into opposing schools: demand-siders versus supply-siders; expansionists versus 'austerians'; and free and efficient market fundamentalists versus those with a deep distrust of the price mechanism. In the meantime, anything approaching an optimal policy mix has been lost in the associated fog of claim and counter-claim, and all the intellectual bitchiness that goes with it.

Pragmatism trumps dogma

Economics is not a pure science. Nor is it a branch of moral philosophy, or higher mathematics. It cannot be distilled down into a series of enduring laws and equations. It does not lend itself to repeated controlled experiments. Rather, it is – or should be – a practical and dynamic discipline, inseparable from a real world of human emotions, unstable preferences, differing cultures, satisfiers rather than maximisers, and imperfect information. And this leaves a lot of room for the interpretation of events and for politics to intervene and influence judgement.

… yet certain truths have been revealed by recent events …

Nevertheless, in reviewing the lead-up to the crisis, the crisis itself, and its aftermath, certain verisimilitudes revealed themselves. Admittedly, some of them are frustratingly imprecise. But nevertheless, surely they offer a better way forward than the unrelenting trench warfare that characterises so much of the contemporary economic debate? It is about time that economists and policymakers set aside the myopia and the preaching and got real. For all our sakes.

Lessons learned

In this spirit, here are what might be described as ten practical principles of economic engagement:

1. **Uncertainty v. Risk**. Unquantifiable uncertainty, as opposed to measurable risk, is a fact of life. Moreover, beyond a certain level, uncertainty can dominate all other considerations in decision-making. In particular, by clouding the future and damping animal spirits, it can constrain spending by both households and corporations and utterly undermine aggregate demand. As a result, economies do not necessarily rapidly self-regulate, smoothly returning to equilibrium. They can become divorced from any notion of full resource utilisation for a protracted period.

2. **Tranquillity causes crises.** Periods of relative macroeconomic and financial calm often tend to embody the seeds of their own destruction, and booms and busts, asset market excesses, and deep recessions are difficult, if not impossible, to avoid. Furthermore, the downturns that follow large financial crises are typically the most intractable. The business cycle cannot therefore be entirely tamed.
3. **Control the cycle.** On the other hand, neither should the business cycle be left to its own devices, the effects of which can *in extremis* prove disastrous for social and political instability. In this context, while undoubtedly a powerful impetus for innovation and enterprise, the danger with putting too much store in 'creative destruction' is that it delivers a very low ratio of creation to destruction.
4. **Seek balance amongst policies**. There is an unarguable role for macro policy activism, and especially in the wake of financial crises. That said, monetary policy is not always as potent as policymakers would like it to be. It generates costs as well as benefits and it can become over-loaded. It works poorly at the zero bound, when there is private-sector balance sheet adjustment, and when uncertainty about the future is high. Hence, notwithstanding the difficulties of co-ordination within and across countries, activism should extend beyond what central banks do to fiscal and macroprudential policy, and pay greater attention to macro imbalances, which can unwind in a disorderly fashion.
5. **Let the automatic stabilisers operate.** These can and should play a key role in managing normal business cycles, and where not already sizeable and well-designed they should be expanded and made more efficient. In contrast, discretionary fiscal stimulus is more suited to deep and extended downturns. Sadly, fiscal policy was compromised by 50 years of over-optimism about its effects and short-sighted, politically-driven, budgetary excess. At the zero interest rate bound, however, the financial constraints on its employment abate.

… and these lessons need to be learned and put to good use ...

6. **Beware concerted consolidation.** Fiscal consolidation is impossible to achieve when everybody is doing it simultaneously and/or when the private sector is deleveraging. Furthermore, 'expansionary fiscal contractions' are rare beasts. They happen only in the most propitious of circumstances.
7. **Fiscal austerity has distinct limits.** Sovereign debt crises are usually the result of private-sector credit booms turned to bust. Greece and Portugal aside, the 2008 crisis had little to do with public sector profligacy *per se*, even if historically-high government debt subsequently complicated the fiscal policy response to it. Overcoming a sovereign debt crisis requires sustained economic growth, a consistently positive inflation rate, and perhaps a dose of debt restructuring. It cannot be cured by fiscal austerity alone, especially within a half-baked currency union.
8. **Pursue structural reform.** Demand management is insufficient. To maximise economic performance, governments must persistently pursue structural policies that encourage the flow of resources from declining and less productive activities to growing and more productive activities, and which leave economies better equipped to absorb shocks: in short, initiatives that increase economies' capacity to adapt to change. This means appropriate strategies to foster competition, education and training, research and development, entrepreneurship, sound infrastructure, trade, foreign direct investment, and flexible labour markets.
9. **Fight the current battle.** Too often, policymakers have ended up continuing to fight the last battle long after it has been won and some new challenge was emerging. And the next crisis is usually very different.
10. **Policy change has to be sustained.** Major shifts in underlying macroeconomic performance are rare. Influences come and go, but economies are often prisoners of long-term considerations such as demographics, if not of their own history, culture, institutions, and politics. To exert an enduring, transformational, impact on these considerations, policy changes have to be substantial and persistent in nature.

… as dogma and intellectual myopia serve no purpose

Inter alia, this list encapsulates elements of Keynes, Minsky, Friedman, Hayek, North, and Schumpeter, if not Marshall and Smith. Intellectual myopia can serve little or no purpose. If the reputations of economics and economic policy are to be revived, then the best ideas of the best minds need to be employed.■

Disclaimer

#Comment: Economic lessons need to be learned and put to good use: 10 practical principles to abandon dogma and myopia, and get real