Economists Out to Lunch

By Robert J. Samuelson
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Niall Ferguson is one of those rare characters: a respected scholar who's also a successful popularizer. Ferguson, a Brit, has taught at Oxford and New York University and is now at Harvard. He has written about World War I, the British Empire and the Rothschilds (Europe's most powerful banking family). He has turned four of his projects into TV documentaries, the latest of which -- "The Ascent of Money," also a book -- begins airing on PBS on Wednesday. It is a program that could be usefully viewed by most of America's roughly 13,000 economists.

One intriguing subplot of the economic crisis is the failure of most economists to predict it. Here we have the most spectacular economic and financial crisis in decades -- possibly since the Great Depression -- and the one group that spends most of its waking hours analyzing the economy basically missed it. Oh, a few economists can legitimately claim some foresight. But they are a handful. Most were as surprised as the rest of us.

Why? This is a compelling question without, as yet, a compelling answer. Indeed, so far as I can tell, economists have not engaged in rigorous self-criticism to explain their lapse. We've had some casual theories and some partisan recriminations: "Free-market ideology" is a standard scapegoat on the assumption that most economists are "free-market ideologues." But that's not true. In any case, the crisis surprised liberal and conservative economists, Republicans and Democrats alike.

This brings us back to Ferguson. The creation of money was a seminal historic event; so was the subsequent invention of finance -- the saving and investing of money. Without them, we could never have moved beyond barter to a modern economy based on specialization and building for the future. But these advances came interwoven with bubbles, crashes, swindles and hyperinflations. Finance has been a wellspring of both progress and instability.

Ferguson is an able guide. He relates the creation of the bond market by Italian city-states in the 14th century as a way to finance their wars against each other; he explains the South Sea and Mississippi "bubbles" in England and France around 1720 -- stock market manipulations based on fantasized riches in the New World; and, finally, he visits the recent housing bubble.

Ferguson's breezy tour suggests two reasons the present crisis embarrassed most economists. The first involves finance itself. The crisis originated in financial markets (the markets for stocks, bonds and many complex securities), and yet finance occupies a peripheral position in mainstream economics. It's studied by a subset of economists, and financial markets -- their ups, downs and side effects -- are not considered big sources of economic expansions and slumps. Economists tend to focus directly on the spending of consumers, businesses and government. It was also widely assumed that deposit insurance and the existence of the Federal Reserve would prevent financial panics.

Well, if you de-emphasize financial markets and financial markets are decisive, you're out to lunch. Financial markets pumped up the real estate bubble; greater housing and stock market wealth inspired a consumer spending boom; losses on "subprime" mortgage securities triggered a collapse of confidence. Some economists have grudgingly, if obscurely, conceded error. A study by the International Monetary Fund called "Initial Lessons of the Crisis" admits: There "was an under-appreciation of systemic risks coming from . . . financial sector feedbacks onto the real economy." That's an understatement.

Overshadowing the misunderstanding of finance is a larger mistake: ignoring history. By and large, most economists don't care much about history. Introductory college textbooks spend little, if any, time exploring business cycles of the 19th century. The emphasis is on "principles of economics" (the title of many basic texts), as if most endure forever. Economists focused on constructing elegant, mathematical models. "For years theorists held the intellectual high ground," writes economic historian Barry Eichengreen of the University of California at Berkeley. They were "the high-prestige members of the profession."

History is messy and constantly changing, as Ferguson reminds us. It flows from institutions, technologies, laws, cultural and religious values, governments, popular beliefs, and much more. Model-building and theorizing can sometimes simplify the real world in ways that provide insights. But often, the models' assumptions depart so radically from reality that the conclusions become useless. Someone who studies history becomes humble in the face of the ceaseless changes and capricious mixing of motives.

Economists thought they had solved the problem of economic stability. Their tools sufficed to prevent widespread economic collapse, even if they couldn't control every twist in the business cycle. This conceit may have once been true. No more. Markets became more complex; more money crossed national borders; people became complacent. History moved on, but economists didn't.