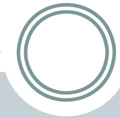
ESOP fabler: The Financial Crisis - a revenge for Keynes?



COMMENT ON LANCE TAYLOR'S TALK, UNIVERSITY OF OSLO, MAY 19, 2010

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Questions for discussion

1) Would we have been more prepared had we all been Keynesian today?

2) Is the recession different this time?

3) Do we have models that are capable of understanding the crisis?

4) How can we pay attention to asset prices?

1) Had we been more prepared had we all been Keynesian today?

- 20’s and 30’s a period of crisis. Business cycle analysis in focus.
- Research centers established all over the world (NBER in USA).
- Post world war & Keynes moved focus from the study of business cycles to macroeconomic policy designed to eliminate the cycles.
- Large scale econometric models. The business cycle is obsolete!
- Instability of the 1970s brought business cycles back on the research agenda.

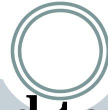
It takes a new model to beat an old model

- Lucas: Reconcile business cycles with the dynamic competitive general equilibrium theory, which relies on rational expectations.
- Real business cycle models (RBC): Kydland and Prescott emphasized real productivity shocks, as opposed to (Keynesian) demand shocks.
- Dynamic stochastic general equilibrium models (DSGE): RBC + Price stickiness. New Keynesian models.
- 1990s: The great moderation - Good policies or good luck. But the business cycle was not under control. So, what now?

2) Is the recession different this time?

- Financial crisis have happened before, although not as severe.
- There has always been a very important interaction between the financial sector and the real economy.
- Recessions caused by financial crisis tend to be deeper and last longer, but it's not a unique event, not something that was completely out of the radar of macroeconomics.
- Some of the central questions rising out of the recession have to do with asset pricing and bubbles.
- How should central banks respond to asset prices?

3) Do we have models that are capable of understanding the crisis



- DSGE models are not designed to predict any sort of crisis. Explain small fluctuations around a fixed steady-state.
- Useful for "normal" times as a way of understanding economic fluctuations, and for learning about optimal policy.
- Need models that can explain abrupt changes. Financial frictions. Had been overoptimistic.
- Policymakers should be more open to alternative models and scenarios. But I do **not** believe we all should be Keynesian!
- Problems at the root of the crisis are micro; Incentives, contracts and regulation. Can we incorporate them in our models?

4) How shall we pay attention to asset prices?

- The real problem is still the conventional wisdom of efficient markets that underlies much of current economic theory.

- Gone too far in interpreting rational expectations and efficiency markets that have ignored the most important dynamics following shocks, like those seen in the financial crisis.

- Growing literature of papers on banks and their misplaced incentives. Also, theory of Learning.

- Features that are not much built into DSGE models yet.

Required actions

- If people are not always rational and do not act entirely out of economic motives, it makes sense to have a government that plays a role in the regulation of markets and engage in activist policy affecting aggregate demand.
- But then it also makes sense to have models that allow for market inefficiencies.
- Adopt a financial instability hypothesis as *one* of our working assumption of how our financial system really works (Minsky theory). Develop many models – not one SUPER model.
- Do policy-makers just want to have simple models? Do they really value academic research?

Conclusion

- There has been an enormous policy intervention compared to the crisis in the 1930s.

- The economic profession should have some credits for providing guidelines as to how policymakers should respond to a crisis of this sort. Have learned from Keynes, but also from Bernanke & Gertler.

- Never trust just one model. The world is too complicated for that. But we should not all be Keynesians.