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How Economists Became So Timid

The field used to be visionary. Now it's just dull.

By Eric Posner and Glen Weyl MAY 06, 2018

The late-18th and 19th-century field of "political economy," from which arose the modern fields of economics, sociology, and political science (among others), contrasts sharply with its contemporary offspring. Political economists drew on all the streams of academic speculation — they were as much philosophers as social scientists, and they recognized none of the distinctions among the various contemporary social sciences. Moreover, they saw themselves as reformists, often radical reformists. The great figures in this tradition include Adam Smith, John Stuart Mill, and Karl Marx. They and their followers searched for solutions to the major economic, social, and political crises of their times. In the process, they gave birth to most modern social ideologies and much of the shape of our present world.

Self-styled American and European radicals, for example, helped end monarchy and expand the franchise. The free-labor ideology of European radicals and American Radical Republicans helped abolish serfdom and slavery and establish a new basis for industrial labor relations. The late 18th and 19th centuries also witnessed the liberal reformism of Jeremy Bentham, Smith, James and John Stuart Mill, and the Marquis de Condorcet; the socialist revolutionary ideologies of Pierre-Joseph Proudhon and Marx; the labor unionism of Beatrice and Sydney Webb; and, influential at the time but now mostly forgotten, the competitive common ownership ideology of Henry George and Léon Walras. This ideology shaped the Progressive movement in the United States, the "New Liberalism" of David Lloyd George in Britain, the radicalism of Georges Clemenceau in France, even the agenda of the Nationalist Chinese revolutionary leader Sun Yat-Sen. The Keynesian and welfare-state reforms of the early 20th century set the stage for the longest and most broadly shared period of growth in human history.

Today, economies around the rich world have stagnated, while inequality has sharply increased. Most citizens in wealthy countries have seen their incomes languish for a generation and have lost faith in the promise of widely shared social progress that has underpinned political stability since the Industrial Revolution. Disillusioned with the status quo, voters from the United States to Italy and beyond have joined reactionary populist movements of the right and left.

So where are the heirs of the political economists? Political economy has fragmented into a series of disparate fields, none of which has the breadth, creativity, or courage to support the reformist visions that were crucial to navigating past crises.

The demise of political economy began in the late 19th century. As academia became more professionalized and specialized, political economy gave way to its successor disciplines — economics, sociology, political science, and the like. By its midcentury nadir, economists hardly interacted with researchers in those other fields.

The transition from a field of creative social visionaries to one of specialized technocrats is epitomized by the story of Alfred Marshall and his star student, John Maynard Keynes. Each had a foot in both worlds and was ambivalent about the change. In many ways, Marshall was the archetype of the 19th-century political economist. Keynes eulogized him, writing that he exemplified the economist who was a "mathematician, historian, statesman, philosopher. … No part of man's nature or his institutions must lie entirely outside his regard … as aloof and incorruptible as an artist, yet sometimes as near to earth as a politician."

Ironically, Marshall's 1890 Principles of Economics — for three generations the field's definitive textbook — marked a decisive transition from this comprehensive vision of political economy. Marshall worked to professionalize and eventually narrow the field. Keynes, despite his flirtations with probability theory and philosophy and his bold vision for transforming economic policy, cemented the position of economists as technocrats — the furthest thing from the aloof, incorruptible artist. The macroeconomic management he advocated requires expert technicians; accordingly, the mid-20th century saw the profession churn out a class of specialized workers. History, politics, sociology, philosophy, and law all drained out of economics.

This is not to say that economics did not incubate any new ideologies after Keynes. University of Chicago economists such as Friedrich Hayek, Milton Friedman, and George Stigler were central to inspiring the "neoliberal" ideology that defined the political careers of Ronald Reagan and Margaret Thatcher. Like the political economists of old, their perspectives were far broader and bolder than those of their contemporaries. But unlike the political economists of old, they did not offer radical social reform or innovation. Instead they advocated a return to institutions that had prevailed in the 19th-century Anglo-Saxon world. All the other major novel ideologies of the period — mostly associated with the New Left: environmentalism, feminism, civil rights, anti-colonialism — developed with almost no input from economics, though they did connect to some currents in sociology, anthropology, and philosophy. And by the 1990s even neoliberalism had transitioned from an insurgency into a consensus governing philosophy administered by a new technocratic class, one that was not much different from the liberal technocracy of the postwar period.

The narrowing of economics took many forms. Academic work shifted away from policy design and toward a combination of formal mathematical theorems and rigorous empirical analysis. Even the areas of economics (public economics and mechanism design) most focused on questions of policy and design sought to address clearly specified problems rather than the complex mishmash of concerns relevant to most practical policy. Similar formalization characterized other fields, like political science and linguistics. The reasons were not always bad ones, and they mirrored broader patterns of professionalization. Economists sought to develop a science on the model of physics because they believed that scientific methods were most conducive to discovering the truth.

Yet even as economists retreated from visionary social theory, the power they wielded over detailed policy decisions grew. A notable feature of this policy guidance was that it shared the narrowness of economists' research methods. Policy reforms advocated by mainstream economists were almost always what we call "liberal technocratic" — either center-left or center-right. Economists suggested a bit higher or lower minimum wage or interest rate, a bit more or less regulation, depending on their external political orientation and evidence from their research. But they almost never proposed the sort of sweeping, creative transformations that had characterized 19th-century political economy.

How to explain this timidity? As with many professions endowed with power (like the military), economics developed strict codes of internal discipline and conformity to ensure that this power was wielded consistent with community standards. While political economists from Smith to Marx drew on a vast range of philosophical influences, economics became one of the most regimented and conformist fields in the academy. Economists have maintained this narrow range of methodological and political commitment through their control of academic journals, hiring, and teaching — as well as through the informal enforcement of community norms. We see this in the treatment of the ideological extremes, the "Austrians" (on the right) and the Marxists (on the left), who have been ostracized from the profession.

The upshot is that economics has played virtually no role in all the major political movements of the past half-century, including civil rights, feminism, anticolonialism, the rights of sexual minorities, gun rights, antiabortion politics, and "family values" debates. It has been completely unprepared for Trumpism and other varieties of populism, having failed to predict those developments just as it failed to predict the financial crisis of 2008. And, until very recently, it has shrugged at one of the most politically charged and morally troubling issues of our time — the rise in inequality.

Even the recent attempts of the field to live up to its heritage have fallen flat. Thomas Piketty's Capital in the Twenty-First Century, while widely perceived as a successor to Marx's Capital, ends by half-heartedly proposing a modest global tax on capital. Where is the modern Smith, Marx, George, or Keynes? Other fields have not stepped up to fill the void left by political economy's collapse. Sociologists and political scientists largely eschew specific policy proposals. And political philosophers, while offering bold visions of ideal societies, usually avoid dirtying their hands with the details of feasible policy design.

Calls for more interdisciplinary work, common as they are, often lead to muddle. What's missing from the social sciences is a willingness at a large scale to revisit the roots of the intellectual traditions that have given rise to the current system of silos in which researchers make incremental advances along familiar paths, proposing modest reforms rather than reimagining our basic institutions. After decades in which fundamental questions were neglected but technical and empirical insights accumulated, political economists have a rich store of material to work with. In an era threatened by rising inequality and authoritarian populism, we hope that boldness rather than caution will be the new watchword of these fields.

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https://qz.com/1181498/rolling-back-regulations-often-comes-before-a-financial-meltdown-according-to-the-imf/

Rolling back regulations often comes before a financial meltdown, according to 300 years of history

By: John Detrixhe, January 19, 2018

The blame for financial meltdowns often focuses on irresponsible traders and greedy bankers. But politicians, whose policies sometimes fan the flames, deserve scrutiny as well, according to a fascinating analysis of booms and busts since the 18th century by Jihad Dagher, an economist at the IMF. The research serves as a warning, of sorts, as the Trump administration seeks to relax banking regulations introduced after the last crisis.

The cycle of booms followed by deregulation, crises, and re-regulation has repeated itself over the past 300 or so years. Take the Financial Crisis of 1825 (pdf): Following the Napoleonic wars and the collapse of the Spanish empire, newly independent states in Latin America were seeking money and European financiers stepped in to lend it to them, as Dagher recounts it. A speculative loan market developed in London, and South American mining companies flocked to the London Stock Exchange. Markets were soaring, and members of parliament sat on the boards of some of the firms quoted on the exchange.
Despite concerns about shaky companies, politicians weakened enforcements and regulations that were put in place after the previous financial crisis—the South Sea Bubble in 1720. By the end of 1825, markets were in a “full blown panic,” according to Dagher’s research. Stock and bond prices crashed, leading to bank runs and failures. A year later, nearly 10% of England’s banks had collapsed, sparking perhaps the first major global banking crisis. Policymakers responded to the turmoil with a range of measures, including trying to shore up the banking system with greater levels of capital: “What ensued from the 1825 crisis was a series of laws, regulations, and reforms that touched all aspects of the financial sector,” according to Dagher.

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Will Dodd-Frank’s stricter standards survive? If history is any guide, Dagher says probably not.

Regulation and enforcement has already been reduced. The Consumer Financial Protection Bureau, which was created after the crisis, is now run by one of its harshest critics. Scores of other measures, from banker bonuses to rules controlling banks’ trading desks, are being reconsidered. There’s bipartisan support in Washington for making smaller banks exempt from stress tests and loosening lending standards.
Some changes could amount to a thoughtful re-calibration, but the direction of travel is worrisome. When it comes to Dodd-Frank, Donald Trump said this week that his administration is “doing a real number on it,” according to The Hill.
Not everyone thinks that’s a good idea. Before he left his post as vice-chairman of the Federal Reserve last year, Stanley Fischer warned in an interview in the Financial Times (paywall) that it was “extremely dangerous and extremely short-sighted” for the US to roll back regulations a mere 10 years since the last crisis.
Since the 2008 collapse, the US economy has dragged itself out of the mire and is growing steadily. Stock markets, meanwhile, are soaring—so much so that some economists have warned they are overheating. The recently passed tax cut, meanwhile, gave those assets an extra boost. Three centuries of history suggests that now could be a time to strengthen supervision rather than water it down.

https://www.lowyinstitute.org/the-interpreter/tide-turning-us-financial-regulation

The tide is turning against US financial regulation

By: Stephen Grenville, Feb. 7th, 2018.

For most of the decade since the global financial crisis, financial regulation has been strengthened. Now the tide is turning in America. Reform has come up against the combined forces of Wall Street lobbying and Donald Trump’s deregulation agenda.

It is beyond dispute that the financial crisis revealed not only serious deficiencies in prudential regulations, but also systematic gaming of the regulations by European and US banks. Alan Greenspan’s view that the self-interest of financial sector management would discipline their actions proved hopelessly out of touch with reality.

The reform efforts have been coordinated at the international level by the Bank for International Settlements, rewriting the Basel rules that focus mainly on ensuring the banks have enough capital to absorb losses. Within this global framework, national regulators have flexibility to modify and add to these rules in order to suit local conditions. Randal Quarles, Trump's appointee in charge of supervision on the Federal Reserve Board, has foreshadowed changes to the US regulatory framework – all favouring Wall Street.

The first proposed change will weaken what has proven to be one of the most effective post-2008 measures: the requirement that banks undergo a "stress test" to simulate the impact of an adverse shock, such as a big fall in GDP, on the balance sheets of individual banks. Stress tests in 2009 were, in fact, the key to restoring public confidence in the US banking system after the crisis.

Since then, however, the banks have complained that they don't know what the simulation shocks will be in advance, so can't prepare themselves properly. This might sound a bit like students asking to be told what their exam questions will be ahead of time. Banks can tweak their balance sheets so that they look good in the context of these specific shocks. Nevertheless, Vice Chairman Quarles seems ready to make the stress tests more "transparent".

The loudest of the bank complaints relates to the "Volcker Rule", even the watered-down version of which was finally agreed upon in 2013. Until 1999 the Glass-Steagall Act separated banking from other financial activities, such as insurance and investment banking. The logic is simple: in a crisis, the banking sector is protected not only by depositor insurance, but also by the understanding that if a substantial bank gets into trouble, it will inevitably be bailed out by the taxpayers to ensure there is no general loss of confidence in the financial system.

The implicit downside of this guarantee is that it may make bankers less diligent and more risk-prone ("moral hazard"), and it certainly means that taxpayers subsidise the full range of risky activities. Thus, even though an implicit guarantee is necessary, it should be confined to the part of the financial sector that is really vital – simple deposit-taking and lending, and the payments system. The taxpayer should not be guaranteeing banks' own-account trading in financial and commodity markets or risk-prone activities, such as derivatives and securitisation.

Of course, this comprehensive coverage suits banks. For a start, the government guarantee means that they can borrow more cheaply. All sorts of arguments, of varying merit, have been put forward in opposition to the Volcker Rule. But the need for this kind of separation has been recognised universally, with the UK and Europe moving to ring-fence traditional banking services.

The most powerful argument in favour of such a separation relates to the diverse nature of finance. A good financial sector should:

•provide funding even for risky ventures

•provide risk-management (such as underwriting IPOs, derivatives and forward cover)

•participate in the full range of financial markets

•be innovative.

All this is desirable and necessary. But providing a government guarantee for banks carrying-out this full range of services not only puts the taxpayer at risk, but also alters the structure of the financial sector. Core banking should be a dull part of finance, run by conservative, risk-averse managers. Without an enforced separation, banks expand their activities into these more exciting activities and are then managed by hard-driving, risk-loving Masters of the Universe. Didn't we learn this lesson in 2008?

This prospective weakening of the Volcker Rule will not cause an immediate collapse of the financial sector. Memories of 2008 are still fresh enough to constrain management and stiffen regulators' spines. But the lessons of the 1930s bank failures lasted for more than half a century. The lessons of 2008 look like they have already been forgotten, or erased.