Economists and Reality (Book Review)

Away from their equations, the theoreticians of modern economics seem quite interested in the real world.

Fortune Magazine, July 9, 1984

Arjo Klamer, an assistant professor of economics at Wellesley [College], has pulled off a remarkable stunt. He has produced a book that deals seriously with the fundamental issues of contemporary economic theory--and that is fun to read. The stunt was made possible by Klamer's somewhat unacademic methodology: instead of interpreting the cryptic texts in the scholarly journals, he turned directly to the authors and talked to them about economics while the tape recorder ran. In Conversations with Economists (Rowman & Allanheld, $18.95), we get to hear 11 eminent members of the profession, ranging from the stars of the "rational expectations" school like Robert Lucas (of the University of Chicago) to neo-Keynesians like Robert Solow (MIT) to Marxists like David Gordon (New School for Social Research). They tell us in plain English what they like about their own models of how the economy works. They also describe the intellectual pilgrimages and accidents of life that led them to those models, and discuss their colleagues' competing models with respect, condescension, and everything in between.

Because of its conversational format, Conversations with Economists is a book you can profitably browse through. Pick it up, turn to any page, and if you have any interest at all in economics you'll probably find yourself reading on. One endlessly fascinating theme in the book is the relationship between those various economic models and "reality." Many people believe--indeed many economists believe--that economic theories are too often accepted on the basis of their methodological sophistication, and without regard to their underlying factual assumptions. Yet Klamer's conversations show his economists worrying a lot about reality. Lucas, the best-known proponent of "rational expectations," confesses at one point: "Sometimes I get so deep into a problem that I just lose the ability to hang on to all the pieces, and start being afraid that I'm thinking about everything in the wrong way. I read criticisms of my work that seem to me important, pointing up serious deficiences in these models." Lucas then adds that he has a "general confidence" that the criticisms don't really undermine his work,

"although I don't know why." Like a lot of other social scientists, economists depend in the end on gut feelings about where the truth lies, and it's refreshing to see some of them acknowledging this.

As Klamer observes in a useful introductory chapter which offers a fast guide to the main points at issue in modern economics, the vision of reality being put forward by the rational expectations school represents a fundamental challenge to other academic models. Lucas and his occasional collaborator Thomas Sargent (of the University of Minnesota) argue that people act as if they're using all available information in trying to anticipate the future, including even the information built into quite sophisticated econometric models; if the argument is valid, then Keynesian interventions won't have the intended effect. As Sargent puts it, individuals can always foil the interventionists by changing their own strategies when the government changes its strategy.

The Keynesians represented in Conversations---they include Solow, Franco Modigliani (MIT), alan Blinder (Princeton), John Taylor (Harvard), and James Tobin (Yale)--have naturally not been kind to rational expectations. They deride the view that ordinary consumers will develop expectations consistent with elaborate theoretical models. that few consumers can understand. (The alternative view is that consumers' behavior can be consistent with the model even if they don't understand it.) The book includes some interesting rhetorical sniping by members of the two schools. Lucas observes at one point: "I don't think that Solow, in particular, has ever tried to come to grips with any of these issues except by making jokes." In his own conversation, Solow acknowledges the jokes but insists that he has his reasons for not getting into detailed arguments. "Suppose," he says, "someone sits down where you are sitting right now and announces to me that he is Napoleon Bonaparte. The last thing I want to do with him is to get involved in a technical discussion of cavalry tactics at the Battle of Austerlitz. If I do that, I'm getting tacitly drawn into the game that he is Napoleon Bonaparte."

Despite these quite fundamental disagreements about what's going on in the real world, the economists represented in Conversations agree on more issues than a non-economist might suppose. For example, economists today generally agree that there is no long-run trade-off between inflation and unemployment. At the

peak of their prestige in the Sixties, the Keynesians insisted that the trade-off was real and argued that high but steady inflation rates could produce low unemployment rates. But the Seventies--a period of both high inflation and high unemployment--led most Keynesians to change their perspectives. Robert Solow, for example, says that his belief in a stable trade-off "was very badly damaged by the data of the Seventies," which led him to change his mind.

Klamer's economists are also pretty well agreed on the harm done by many government policies. Monetarists and economists working in the classical tradition have long believed that price controls create shortages without reducing inflation rates. But most Keynesians now oppose controls too. About the only Keynesian still advocating them is James Tobin, Yale's Nobel laureate. And Tobin admits that the case for controls "is not an argument to which most members of the profession would agree."

To be sure, there are important differences of emphasis on the role of government. Solow and Blinder support more government interventions, and Solow says he would be willing to see democratic socialism given a try. Even so he acknowledges the danger of socialism," which is "the concentration of political and economic power in the same hands." Blinder identifies himself as one whose bedrock belief is sympathy for the underdog--and opposes the minimum wage precisely because it hurts society's underdogs (by reducing job opportunities for unskilled workers).

Even where they disagree, the Keynesians and the more classical economists aren't as far apart as many might suppose. Question: why are workers laid off during recessions? The supplied by both sides is that layoffs occur because wage rates don't fall along with the demand for labor. The view that employment depends on wage rates, although foreign to most educated Americans, is second nature to economists. The issue that remains contentious among them is why wages don't fall along with demand. Or, more precisely, why have they fallen at some times but not others? Lucas notes that they fell by about half between 1929 and 1933; he adds that he is puzzled by their failure to fall further during the years of high unemployment in the later Thirties.

However, several of the economists represented in Conversations think they

know why wages tend to be rigid during downturns. Tobin, Modigliani, and Taylor, all Keynesians, attribute wage rigidity to the existence of long-term union contracts. This hypothesis is also supported by two of Klamers's more classical scholars, Sargent and Robert Townsend (of Carnegie-Mellon). Klamer often seems to be trying to emphasize the differences among his 11 economists, but many readers will surely be struck by the extent of the agreements.

The agreements do not extend to the two radicals among the eleven. David Gordon, one of the best-known radical economists in the U.S. today, goes so far as to challenge the view that consumers have choices. According to Gordon, people in fact have few choices to make because so many of them live at subsistence levels. You have to marvel at the ability of some sophisticated economists to hold beliefs so palpably at odds with reality.

Leonard Rapping, the other radical economist interviewed, attributes his present posture to his experiences during the Vietnam war. Rapping, now based at the University of Massachusetts, began as a free-market economist but says that he rejected the "Chicago School" because his teacher, Milton Friedman, "never mentioned anything about foreign policy or defense." What this seems to mean is that Friedman's failure to discuss issues on which he was not an expert led Rapping to doubt the validity of Friedman's views in areas where his expertise was unquestioned. The non sequitur here seems bizarre, and it is interesting to contrast Rapping's experience with that of Thomas Sargent, who became more of a free-market believer because of Vietnam. Sargent tells us that he left Berkeley and Harvard believing strongly in government interventions. During the war he served for a time in the Pentagon, where his tour of duty left him broadly doubtful about the effectiveness of government policymakers.

For many readers, one of the rare pleasures offered by Conversations with Economists is the book's high-level presentations of issues in a format free of equations. You do not have to be a specialist in the humanities to worry that modern economics is too mathematical. Two of the 11 economists interviewed--Blinder and Karl Brunner, the eminent monetarist from the University of Rochester--express concern that valuable insights are sometimes ignored because it is difficult or impossible to express them in quantitative terms. Brunner worries, for example, about the conviction of many younger economists "that

whatever is not explicitly and rigorously formalized does not count, and cannot possibly contribute any relevant knowledge." Klamer's book shows that even at the theoretical heights, economic knowledge can be conveyed in plain English.