Economists and the crisis
Andrew Oswald, David Blanchflower and Mark Taylor reflect on different aspects of the current financial upheavals. It is striking that each, independently and without any prompting from the editor, concludes with the thought that economists have a lot to learn and should be suitably humble in future.

If you sail on a flat sea for long enough, you start believing you made the sea flat.

Recent events have reminded us — especially central bankers, home buyers, investors and economists — of the risks inherent in an economic system. In different ways, we all learnt a little humility (in 2003 and 2004 I argued that a large housing crash was likely, but I got its timing wrong). As economists, we have to accept part of the responsibility for what has happened. It is the job of experts to prevent crises in the domains in which they are meant to be expert. In this sense, economists have let down the country. Some will favour mental gymnastics that allow us to shrug off a recession and blame. But in my view the grown-up thing is to admit it, swallow our pride, and work out how the profession can do better next time.

Four points
First, for reasons explained below, herd behaviour lies at the heart of all this. Economists think too little about herds. That needs to change.

Second, economists should have spoken up more about the dangers of the international housing bubble. We ought to have publicised the attached UK graph and repeatedly explained to ordinary citizens that the lesson of history was that a housing crash was likely. Even those economists who wrote articles and made speeches saying — I sat through one made in the middle of the decade to 500 Warwick students about to buy their first home — that it was not a bubble should have shown audiences this graph and at least warning them of the possibilities. It is hard to see how we can avoid some culpability here. As I write this (early in December 2008), new numbers came out this morning showing that UK house prices fell more than 2 per cent in the last month. It is tricky to know how long this will go on, but we are still quite far from trend.

Third, the triumphalist over the last decade of some Monetary Policy Committee members was not sensible. It is easy, I accept, to be wise after events. Let’s be more cautious next time and wait for many more data points to accrue.

Fourth, it is not true, despite the views of our critics, that economists gave no warnings. At the start of 2008, the usual annual Financial Times poll of economists reads in retrospect as full of worries, but it is true that we did not think a disaster was probable.

To return to point 1, in my judgement it was herd behaviour that began the crisis. Downward overshooting by the herd remains a danger as we go into 2009 and onwards.

Why do herds form? I do not believe it is greatly to do with learning from others, which is the standard model of herd behaviour, in so far as it exists. What matters instead is that there is a lot of noise — too many people reading the same report, the same newspaper, the same newspaper review of the same film. So in my view we have one (a nice summary of that literature is available in Chalmers 2003). I think that literature is mostly a red herring.

UK Real House Prices

The reasons for herd behaviour
Herdsonics happens when relative position matters. Real-life utility functions contain relative things, like income, as arguments.

People paid extraordinarily high prices for houses, even though not justified by fundamentals, because they felt they were trailing behind the Joveses. Brokers sold unsold mortgages because they had to keep up with rival brokers. Money managers — often remunerated on their relative performance against other managers — traded shares with the same motive. People were frightened about being left behind in their particular pecking order. Humans care deeply about rank.

Conventional economics contains little recognition of such actions. The word ‘herd’ does not appear in most textbooks. In consequence, those texts do not offer an intellectual framework that could have predicted, or can help policy-makers in, our current dilemma.

The research journals are not much better. Since 1970, on an electronic count, only 3 out of the last 8000 articles in the Economic Journal discuss herd behaviour; 2 out of 2000 articles in the Quarterly Journal of Economics; and 4 out of 1500 articles in the Journal of Financial Economics. It would be difficult to prove that this is a reason why the world is in a mess. But at least some suggests that the market is a contributing factor. Just as before the Great Depression, economists and central bankers have been using the wrong model of human behaviour.

In my judgment, it will be necessary to rework economics. We are going to have to bring the idea of relative comparison into the centre of our thinking. A good place to start is Hamilton’s article on defensive herding in the 1971 Journal of Theoretical Biology. It is about real herds and why animals cluster together for relative safety. I would like to hope that some contribution is also made by work by Andrew Clark and myself in, for example, the 1998 Journal of Public Economics. We argue that convexity leads to deviance while concavity leads to people following others. Mathematically, this is nothing to do with learning; it is instead the product of humans caring about where they rank in a hierarchy.

As Miller and Siggelkow (2008) argue, we also have to have, more broadly, a different macroeconomic apparatus.

Finally
In a world with herd behaviour, there is an intellectual case for government intervention to internalise the externalities created. The cool-headed individuals of our unrealistic traditional textbooks do not need to be regulated. Unfortunately, herds do.

A bit more humility from our profession is called for in future.

Note:
1. University of Warwick. I am grateful to Richard Cooper for excellent research assistance, and I thank Liam Graham and Christophe Chami for helpful discussions.

References

The Economy - David G Blanchflower

I argued throughout 2008, including in speeches in April and October, that the MPC needed to be aggressive in setting interest rates to prevent the UK entering recession. Over the last three months, Bank Rate has been cut to two percent, its lowest level since 1951. Bank Rate was cut by 50bps in November, and 100bps in December. Throughout 2008 I held the view that without aggressive cuts, the UK faced the prospect of a relatively deep and long-lasting recession — primarily because it has greater dependence on the financial sector, a bigger house price bubble, and a higher growth in household debt than in the United States. Unfortunately, these three interest rate cuts were not sufficiently timely to prevent the UK from entering recession.

The NBER recently dated the start of the recession in the United States to December 2007, when payroll employment started to fall, even though this does not conform to the technical definition of a recession (two quarters of negative growth). I would date the start of the UK’s recession to have been in February 2008, when the recession to have been in February 2008, when the LFS employment started to fall (even though this date does not conform to the technical

normal definition of a recession either — GDP growth was zero percent in the second quarter of 2008, and minus 0.5 percent in the third quarter).

The UK has been buffeted by two economic forces. The first was higher global energy and food prices, which posed an added risk to inflation and the possibility of a wage-price spiral if inflation expectations became entrenched. Inflation did rise, reaching 5.2 percent in September (its highest level since 1992), but it fell back to 4.5 percent in October. I expect it to fall back very sharply to well below the MPC’s two percent target in 2009. Oil has fallen to $45 a barrel since its peak of $147 a barrel in summer 2008. There has been no wage-price spiral. The UK labour market is far more fluid than it used to be — few wage settlements are now explicitly inflation-linked, and union power has diminished. Workers are more concerned about keeping their jobs (which is dependent on firms’ employment intentions and profitability) than inflation.

Wage growth is now falling, the fear of unemployment is rising, and household inflation expectations have plummeted.
Inflation expectations did rise as inflation increased, but are now falling even faster than inflation. November’s Citigroup survey, for example, showed a record plunge in short-term inflation expectations — from 2.9 per cent to 0.9 per cent, well below the Bank’s inflation target.

The second economic force — the global credit crunch — posed a much more worrying downside risk to inflation and output. This risk has materialised. Policy-makers are now faced with unprecedented global financial turmoil — money markets are dysfunctional, banks are not willing to lend to each other unless at the very short-term, governments globally have been recapitalising financial institutions, and several institutions have collapsed. There has been a dramatic fall back in risk appetite, and chronic concerns over the credit-riskiness of the financial institutions themselves. Financial institutions have made huge losses, and written-down the value of complex risky assets (such as mortgage backed securities and their derivatives). Dependence on short-term funding, often through sales of securitised assets (whose markets have dried up) has left many institutions exposed to tightening credit conditions.

But I believe the impact of the credit crunch on the real economy was broadly predictable. Developments in the UK closely followed those in the US, but with a six-to-nine-month time lag. There was a synchronised downturn in many UK business surveys around the beginning of 2008; this should have led us to realise sooner that the UK economy was entering recession. A similar pattern (the turning of business surveys) occurred in the US a few months earlier. We are now starting to see the impact of the credit crunch on the wider economy. In the third quarter, UK GDP contracted by 0.5 per cent, the biggest contraction since the early 1990s. I expect growth in the fourth quarter of 2008 and first quarter of 2009 to be worse. Unemployment has risen at its fastest pace in seventeen years: LFS unemployment rose to 1,825,000 in September 2008, or 5.8 per cent. I expect unemployment to continue to rise through 2009 and into 2010, probably to over three million.

And I believe the impact of constrained credit conditions has yet to fully feed through to the broader economy, particularly to investment by firms. Lending to households and firms is likely to be reduced further in the near term.

This is because of the ‘collateral effect’: higher interest rates push down on equity and house prices, eroding the value of firms’ and households’ collateral. This makes firms and households riskier prospective borrowers, so lenders tighten credit availability further. There has been considerable tightening in mortgage lending in the UK, and significant falls in house prices. Firms appear to have been drawing on pre-committed lines of credit (that banks have financed through sales of foreign assets), but once these lines are exhausted then firms will be fully exposed to tighter credit conditions. Investment is likely to fall back sharply, and there is a growing risk that firms will close, net job creation will fall and redundancies will increase.

The construction sector has been particularly exposed to the effects of the credit crunch; activity has fallen sharply and is unlikely to pick up until residential and commercial property prices stabilise. We might expect growth in UK exports given sterling’s depreciation, but global demand is slowing, as many other economies enter recession. This is a global shock. Annual UK sales of new cars fell 36.8 per cent in November, the steepest fall in nearly thirty years. And the CIPS survey of manufacturing output fell by a record amount in November; the survey already stood at its lowest level since it began in 1991. The CIPS survey for services was also at an historic low in November. The CBI Distributive Trades Surveys, and surveys conducted by the British Chambers of Commerce, the Engineering Employers Federation, and the KPMG/REC Report on Jobs also confirm the dire news.

Output data bounce back from recessions. The UK economy will ultimately return to prosperity. But I believe it has entered recession, and I am concerned that inflation will fall below one percent, possibly even turning negative, causing the MPC to write to the Chancellor explaining why inflation is below the Bank’s inflation target. The 2.5 percent reduction in VAT announced by the Chancellor in November’s Pre-Budget Report will push inflation down further in the near term. In circumstances where there is a danger of deflation and policy interest rates are approaching the zero bound, it is appropriate to consider the use of alternative policy measures, including quantitative easing.

The last decade has been described as a period of ‘great stability’, partly attributable to improved monetary policy. But this stability has ended with turmoil in the global financial system. The counterparty to ‘irrational exuberance’ in an upswing appears to be excessive credit tightening in a downswing.

Over the past decade, central banks have been analysing monetary policy using worst case models taken from the new Keynesian Phillips Curve literature. Such models are more in the tradition of Friedman, stressing the importance of inflation expectations. But they have little scope for the role of financial intermediation, money supply growth, asset prices, and changes in the structure of wage-setting. These models have proved to be an extremely poor tool for monetary policy. We are experiencing the greatest financial shock in a century, and our current framework for monetary policy essentially assumed this shock could not happen. The events of the last twelve months represent a huge challenge to econo-
mists: it is probably time for a big rethink.

Notes:
1. Bruce V. Rauzer Professor of Economics, Dartmouth College, University of Stirling, NBER, IZA, CEStm and Member, Monetary Policy Committee, Bank of England.
2. See Blanchflower (2008), ‘Inflation, expectations and mone-
coming), April.
3. The question asked was, ‘How do you expect prices in the shops to change generally over the next twelve months?’
4. For a discussion of such measures see, for example, Eln Beneske (2002), ‘Deflation: making sure “it doesn’t happen here”,’ http://www.federalreserve.gov/boardeocs/speech-