Five Zombie Economic Ideas That Refuse to Die

Two years after the financial crisis, the U.S. economy has steered clear of total disaster, with the Dow Jones industrial average currently near its pre-crash level. But the theories that caused it all are still out there, lurking in the shadows.

BY JOHN QUIGGIN  |  OCTOBER 15, 2010

The global financial crisis that began with the collapse of the U.S. subprime mortgage market in 2007 ended by revealing that most of the financial enterprises that had dominated the global economy for decades were speculative ventures that were, if not insolvent, at least not creditworthy.

Much the same can be said of many of the economic ideas that guided policymakers in the decades leading up to the crisis. Economists who based their analysis on these ideas contributed to the mistakes that caused the crisis, failed to predict it or even recognize it when it was happening, and had nothing useful to offer as a policy response. If one thing seemed certain, it was that the dominance of the financial sector, as well as of the ideas that gave it such a central role in the economy, was dead for good.
Three years later, however, the banks and insurance companies bailed out on such a massive scale by governments (and ultimately the citizens who must pay higher taxes for reduced services) have returned, in zombie form. The same reanimation process has taken place in the realm of ideas. Theories, factual claims, and policy proposals that seemed dead and buried in the wake of the crisis are now clawing their way through the soft earth, ready to wreak havoc once again.

Five of these zombie ideas seem worthy of particular attention and, if possible, final burial. Together they form a package that may be called "market liberalism," or, more pejoratively "neoliberalism." Market liberalism dominated public policy for more than three decades, from the 1970s to the global financial crisis. Even now, it dominates the thinking of the policymakers called on to respond to its failures. The five ideas are:

**The Great Moderation:** the idea that the period beginning in 1985 was one of unparalleled macroeconomic stability that could be expected to endure indefinitely.

Even when it was alive, this idea depended on some dubious statistical arguments and a willingness to ignore the crises that afflicted many developing economies in the 1990s. But the Great Moderation was too convenient to cavil at.

Of all the ideas I have tried to kill, this one seems most self-evidently refuted by the crisis. If double-digit unemployment rates and the deepest recession since the 1930s don't constitute an end to moderation, what does?

Yet academic advocates of the Great Moderation hypothesis, such as Olivier Coibion and Yuriy Gorodnichenko, have stuck to their guns, calling the financial crisis a "transitory volatility blip."

More importantly, central banks and policymakers are planning a return to business as usual as soon as the crisis is past. Here, "business as usual" means the policy package of central bank independence, inflation targeting, and reliance on interest rate adjustments that have failed so spectacularly in the crisis. Speaking at a symposium for the 50th anniversary of the Reserve Bank of Australia this year, European Central Bank head Jean-Claude Trichet offered the following startlingly complacent analysis:

We are emerging from the uncharted waters navigated over the past few years. But as central bankers we are always faced with new episodes of turbulence in the economic and financial environment. While we grapple with how to deal with ever new challenges, we must not forget the fundamental tenets that we have learned over the past decades. Keeping inflation expectations anchored remains of paramount importance, under exceptional circumstances even more than in normal times. Our framework has been successful in this regard thus far.

**The Efficient Markets Hypothesis:** the idea that the prices generated by financial markets represent the best possible estimate of the value of any investment. (In the version most relevant to public policy, the efficient
markets hypothesis states that it is impossible to outperform market valuations on the basis of any public information.)

Support for the efficient markets hypothesis has always relied more on its consistency with free market ideas in general than on clear empirical evidence.

The absurdities of the late 1990s dot-com bubble and bust ought to have killed the notion. But, given the financial sector’s explosive growth and massive profitability in the early 2000s, the hypothesis was too convenient to give up.

Some advocates developed elaborate theories to show that the billion-dollar values placed on companies delivering dog food over the Internet were actually rational. Others simply treated the dot-com bubble as the exception that proves the rule.

Either way, the lesson was the same: Governments should leave financial markets to work their magic without interference. That lesson was followed with undiminished faith until it came to the edge of destroying the global economy in late 2008.

Even now, however, when the efficient financial markets hypothesis should be discredited once and for all, and when few are willing to advocate it publicly, it lives on in zombie form. This is most evident in the attention paid to ratings agencies and bond markets in discussion of the "sovereign debt crisis" in Europe, despite the fact that it was the failure of these very institutions, as well as the speculative bubble they helped generate, that created the crisis in the first place.

**Dynamic Stochastic General Equilibrium (DSGE):** the idea that macroeconomic analysis should not be concerned with observable realities like booms and slumps, but with the theoretical consequences of optimizing behavior by perfectly rational (or almost perfectly rational) consumers, firms, and workers.

DSGE macro arose out of the breakdown of the economic synthesis that informed public policy in the decades after World War II, which combined Keynesian macroeconomics with neoclassical microeconomics. In the wake of the stagflation of the 1970s, critics of John Maynard Keynes like University of Chicago economist Robert Lucas argued that macroeconomic analysis of employment and inflation could only work if it were based on the same microeconomic foundations used to analyze individual markets and the way these markets interacted to produce a general equilibrium.

The result was a thing of intellectual beauty, **compared** by the IMF’s chief economist, Olivier Blanchard, to a haiku. By adding just the right twists to the model, it was possible to represent booms and recessions, at least on the modest scale that prevailed during the Great Moderation, and derive support for the monetary policy.
But when the crisis came, all this sophistication proved useless. It was not just that DSGE models failed to predict the crisis. They also contributed nothing to the discussion of policy responses, which has all been conducted with reference to simple Keynesian and classical models that can be described by the kinds of graphs found in introductory textbooks.

Economist Paul Krugman and others have written that the profession has mistaken beauty for truth. We need macroeconomic analysis that is more realistic, even if it is less rigorous. But the supertanker of an academic research agenda is hard to turn, and the DSGE approach has steamed on, unaffected by its failure in practice. Google Scholar lists 2,600 articles on DSGE macro published since 2009, and many more are on the way.

**The Trickle-Down Hypothesis:** the idea that policies that benefit the wealthy will ultimately help everybody.

Unlike some of the zombie ideas discussed here, trickle-down economics has long been with us. The term itself seems to have been coined by cowboy performer Will Rogers, who observed of U.S. President Herbert Hoover's 1928 tax cuts: "The money was all appropriated for the top in the hopes that it would trickle down to the needy. Mr. Hoover ... [didn't] know that money trickled up."

Trickle-down economics was conclusively refuted by the experience of the postwar economic golden age. During this "Great Compression," massive reductions in inequality brought about by strong unions and progressive taxes coexisted with full employment and sustained economic growth.

Whatever the evidence, an idea as convenient to the rich and powerful as trickle-down economics can't be kept down for long. As inequality grew in the 1980s, supply-siders and Chicago school economists promised that, sooner or later, everyone would benefit. This idea gained more support during the triumphalist years of the 1990s when, for the only time since the breakdown of Keynesianism in the 1970s, the benefits of growth were widely spread, and when stock-market booms promised to make everyone rich.

The global financial crisis marks the end of an economic era and provides us with a position to survey how the benefits of economic growth have been shared since the 1970s. The answers are striking. Most of the benefits of U.S. economic growth went to those in the top percentile of the income distribution. By 2007, just one out of 100 Americans received nearly a quarter of all personal income, more than the bottom 50 percent of households put together.

The rising tide of wealth has conspicuously failed to lift all boats. Median household income has actually declined in the United States over the last decade and has been stagnant since the 1970s. Wages for males with a high school education have fallen substantially over the same period.

Whatever the facts, there will always be plenty of advocates for policies that favor the rich. Economics commentator Thomas Sowell provides a fine example, observing, "If mobility is defined as being free to move,
then we can all have the same mobility, even if some end up moving faster than others and some of the others do not move at all."

Translating to the real world, if we observe one set of children born into a wealthy family, with parents willing and able to provide high-quality schooling and "legacy" admission to the Ivy League universities they attended, and another whose parents struggle to put food on the table, we should not be concerned that members of the first group almost invariably do better. After all, some people from very disadvantaged backgrounds achieve success, and there was no law preventing the rest from doing so.

Contrary to the cherished beliefs of most Americans, the United States has less social mobility than any other developed country. As Ron Haskins and Isabel Sawhill of the Brookings Institution have shown, 42 percent of American men with fathers in the bottom fifth of the income distribution remain there as compared to: Denmark, 25 percent; Sweden, 26 percent; Finland, 28 percent; Norway, 28 percent; and Britain, 30 percent. The American Dream is fast becoming a myth.

**Privatization:** the idea that nearly any function now undertaken by government could be done better by private firms.

The boundaries between the private and public sectors have always shifted back and forth, but the general tendency since the late 19th century has been for the state’s role to expand, to correct the limitations and failures of market outcomes. Beginning with Prime Minister Margaret Thatcher’s government in 1980s Britain, there was a concerted global attempt to reverse this process. The theoretical basis for privatization rested on the efficient markets hypothesis, according to which private markets would always yield better investment decisions and more efficient operations than public-sector planners.

The political imperative derived from the "fiscal crisis of the state" that arose when the growing commitments of the welfare state ran into the end of the sustained economic growth on which it was premised. The crisis manifested itself in the "tax revolts" of the 1970s and 1980s, epitomized by California’s Proposition 13, the ultimate source of the state's current crisis.

Even in its heyday, privatization failed to deliver on its promises. Public enterprises were sold at prices that failed to recompense governments for the loss of their earnings. Rather than introducing a new era of competition, privatization commonly replaced public monopolies with private monopolies, which have sought all kinds of regulatory arbitrage to maximize their profits. Australia’s Macquarie Bank, which specializes in such monopoly assets and is known as the "millionaires’ factory," has shown particular skill in jacking up prices and charges in ways not anticipated by governments undertaking privatization.

Privatization failed even more spectacularly in the 21st century. A series of high-profile privatizations, including...
those of Air New Zealand and Railtrack in Britain, were reversed. Then, in the chaos of the global financial crisis, giants like General Motors and American International Group (AIG) sought the protection of government ownership.

Sensible proponents of the mixed economy have never argued that privatization should be opposed in all cases. As circumstances change, government involvement in some areas of the economy becomes more desirable, in others less so. But the idea that change should always be in the direction of greater private ownership deserves to be consigned to the graveyard of dead ideas.

Despite being spectacularly discredited by the global financial crisis, the ideas of market liberalism continue to guide the thinking of many, if not most, policymakers and commentators. In part, that is because these ideas are useful to rich and powerful interest groups. In part, it reflects the inherent tenacity of intellectual commitments.

Most importantly, though, the survival of these zombie ideas reflects the absence of a well-developed alternative. Economics must take new directions in the 21st century if we are to avoid a repetition of the recent crisis.

Most obviously, there needs to be a shift from rigor to relevance. The prevailing emphasis on mathematical and logical rigor has given economics an internal consistency that is missing in other social sciences. But there is little value in being consistently wrong.

Similarly, there needs to be a shift from efficiency to equity. Three decades in which market liberals have pushed policies based on ideas of efficiency and claims about the efficiency of financial markets have not produced much in the way of improved economic performance, but they have led to drastic increases in inequality, particularly in the English-speaking world. Economists need to return their attention to policies that will generate a more equitable distribution of income.

Finally, with the collapse of yet another economic "new era," it is time for the economics profession to display more humility and less hubris. More than two centuries after Adam Smith, economists have to admit the force of Socrates's observation that "The wisest man is he who knows that he knows nothing."

Every crisis is an opportunity. The global financial crisis gives the economics profession the chance to bury the zombie ideas that led the world into crisis and to produce a more realistic, humble, and above all socially useful body of thought.
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