Economists Rush to Disagree About Crisis Solutions

Some economists say the stimulus plan will only make things worse. Others admit they don’t know the right course

By Peter Coy

If the U.S. economy is a sick patient on the operating table, then economists are angry surgeons fighting for control of the scalpel and accusing one another of gross incompetence.

It's bad enough that few economists predicted how bad things would get. What's worse is that even now the profession is foggy and conflicted about how to get out of this mess. That's distressing, to say the least, given the government report on Mar. 6 that the economy lost 651,000 jobs in February. The unemployment rate shot up to 8.1%, its highest since 1983.

The main thing economists are battling over is whether the U.S. economy needs a large jolt of government spending. Those who think so—probably a majority—say the economy is at risk of sinking into a self-sustaining spiral, where a drop-off in consumer spending forces companies to cut jobs, leading to further cutbacks by consumers, and so on into a deeper hole.

A KEYNESIAN "DANGEROUS SPIRAL?"

But a vociferous contingent of economists says that deficit spending by the government would only make matters worse. Many of them argue that the economy is going through a healthy and necessary "reset" in which spending, investment, and stock prices are being adjusted downward to reflect a lower and more sensible reassessment of long-term growth expectations.

So, which are we experiencing—a dangerous spiral or a necessary reset? Most of the economists in the "dangerous spiral" camp agree more or less with the late British economist John Maynard Keynes, who warned that economies can get stuck in a trough of insufficient demand for goods and services. He advocated fighting the Great Depression by using government spending to lift demand.

Today a majority of academic and professional economists buy into at least some of what Keynes had to say. For example, a Wall Street Journal (NWS) survey in February of 52 economists concluded that job losses over the next year would be about a million greater without the Obama stimulus plan than with it. In a Mar. 6 interview with BusinessWeek, Nariman Behravesh, chief economist of IHS Global Insight, a widely followed forecasting outfit, said that "the fiscal stimulus is fine in the sense that it's big and fairly bold." If anything, he said, it should be bigger and start working sooner.

CONTEMPT FOR PAUL KRUGMAN

But that view is hardly unanimous. In late January The New York Times (NYT) published a full-page ad signed by about 250 economists, including Nobel laureates and other luminaries, slamming the Obama plan and saying,
"Notwithstanding reports that all economists are now Keynesians... we the undersigned do not believe that more government spending is a way to improve economic performance."

These days some of the anti-Keynesians barely recognize the Keynesians' existence. In an interview on Mar. 6, one of the signers of the New York Times' open letter, Nobel laureate Edward Prescott of Arizona State University's W.P. Carey School of Business, argued that "no respectable macroeconomist" believes stimulus works. Prescott said 2008 Nobelist Paul Krugman, the Princeton University professor and Times columnist who advocates stimulus, "doesn't command respect in the profession." Prescott argues that what the economy really needs is tax cuts and a commitment to increase productivity, in part by eliminating wasteful regulation. Of Obama, he says: "His policies are designed to depress the economy and are depressing the economy."

The squabbling is embarrassing to the economics profession, which likes to see itself as a true science with consistent axioms and verifiable claims. In the inaugural issue of the American Economic Assn.'s Macroeconomics journal published earlier this year, Columbia University economist Michael Woodford asserted, "Has there been a convergence of views in macroeconomics? Of course..."

WHAT TO MAKE OF "SYSTEMIC FAILURE?"

The fact is that it's hard to see much evidence of "convergence" in the policy debates. Paul Willmott, a specialist in quantitative finance, wrote in a Jan. 1 blog post that where economists go wrong is in trying to construct an intellectual edifice out of crumbly material. Willmott blasted former Federal Reserve Chairman Alan Greenspan for arriving belatedly at the conclusion that the world does not work as neatly as the textbooks say. "Ohmigod!" Willmott wrote. "His naivety [sic] and lack of self-knowledge is staggering....The edifice of nonsense has collapsed on top of one of its builders."

Economists naturally don't like being accused of cluelessness. David S. Evans, vice-chairman of LECG Europe (XPRT), an economic consulting firm, says economists can't be blamed for being befuddled by the current crisis because "we're looking at a systemic failure that's very different from what we've seen before." He said, "It's kind of like AIDS in a sense. It all of a sudden hits. You don't know where it came from or how to treat it."

Duke University economist Campbell Harvey says that given the inherent imprecision in social sciences, it's not so bad that economists disagree. "I think it's a good thing that there are arguments," Harvey said. "We hope that policymakers listen to the debate and make the right choices."

LACK OF LIQUIDITY CAME AS A SHOCK

OK. But if all that economists can do is offer policymakers a range of conflicting choices, it's not clear how much they're contributing to the debate. Willem Buiter, a professor at the London School of Economics and former Bank of England policymaker, wrote in a February blog that modern macroeconomics—meaning not just the Keynesian side but the monetarist side as well—was caught completely off-guard by the drying up of liquidity in financial markets and lending.

It's clear by now that mainstream economists deserve part of the blame for the mess we're in now—along with Wall Street, the Federal Reserve, lawmakers, Presidents, ratings agencies, mortgage bankers, appraisers, and journalists, among others. The so-called dismal science is showing at least some signs of humility. Buiter says approvingly that the Bank of England "has by now shed the conventional wisdom of the typical macroeconomics training of the past few decades." What's replacing it, he says, is not a bold new concept of how the economy works, but "an intellectual potpourri of factoids, partial theories, empirical regularities without firm theoretical foundations, hunches, intuitions and half-developed insights." That, Buiter says, "is not much, but knowing that
you know nothing is the beginning of wisdom."

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