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The Nobel and the Debate Over the Markets

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Last June, I reviewed a book, "*Beyond Mechanical Markets: Asset Price Swings, Risk, and the Role of the State*" by New York University economist Roman Frydman and the University of New Hampshire's Michael Goldberg that probably struck readers as even more arcane than usual. The review was part of my quixotic attempt to read as many of the books about the financial crisis as possible. It seemed to me that Frydman and Goldberg, who have been building a critique arguing that the prevailing orthodoxies of economics, including the rational expectations hypothesis and the New Keynesian approach, were fundamentally flawed. I was attracted to the "fundamental" part. Anyone, even an amateur observer of economics like me, could see that for all its pretensions, most famously as a predictive discipline, economics lurched off the road regularly. Frydman and Goldberg offered an explanation. Both orthodoxies viewed markets as mechanical, they argued, that is, driven by universal relations between cause and effect (the fact that each perspective emphasized different relations should be a sign something was awry). Frydman and Goldberg called these ways of understanding markets predetermined. In fact, they insisted, markets are not predetermined at all; instead they're arbiters of nonroutine change, that is, the kind of technological or political uncertainty no one can predict or foresee.

There's a lot more to this than this simple formulation. Frydman and Goldberg are not economically nihilistic. They offer an alternative to mechanical approaches, which uses mathematical models, but they reject the premise that you can understand markets in mechanical terms. They argue that you can learn more about the world once you start recognizing the limits of what we can know. Beyond that, I'd suggest getting a copy of *Beyond Mechanical Markets* and let them lay it out.

Why bring this up now? Frydman and Goldberg's book did not exactly catch fire, despite its excellent timing. It got respectful reviews, but even there it was often viewed under the obscure banner of economic methodology. It wasn't exactly book club fodder. Then came an odd stroke of fortune. Last week, the Swedish Academy of Sciences awarded the Nobel Prize in economics to two highly credentialed American academics, Thomas Sargent of New York University and Christopher Sims of Princeton. Both men had been at the forefront of building models based on rational expectations. The immediate reaction both in the press and in the blogosphere was respectful. Neither the Swedish Academy nor the early reports felt the need to wonder why, if their approach to model-building was so deserved, the world was in such a mess. And no one initially went near the debate that the gap between theory and reality suggests -- over the nature of markets that *Beyond Mechanical Markets* tackles.

That has now begun to change, evidence perhaps of the role the blogosphere increasingly plays in economic debate -- the subject of a post earlier this week from Paul Krugman, "Our blogs, ourselves." Over the past week, several econo-bloggers and a columnist have emerged to raise questions about the Sargent and Sims choice; in each case they've mentioned *Beyond Mechanical Markets*. Economist Arnold Kling on his blog led off on Oct. 13 with a judicious consideration of the prize. Kling recognized the influence Sims and Sargent have had but wondered: "It would be hard for me to argue convincingly that the average citizen feels the impact of all of the resulting research. It has settled nothing important."

Their models, he wrote, embody a rational-expectations approach. "Rational expectations in the Sargent-Sims tradition treats everyone as having the same model with which to form expectations. As Frydman and Goldberg point out ... this assumes away the local knowledge and tacit knowledge that Hayek correctly identified as being very important in the economy. Indeed, if Sargent and Sims represent a slap in the face to Keynes, they must be regarded as a knee to the groin of Hayek. Hayek coined the term 'scientism' to describe the pretentious pose that economists strike when they equate mathematics with rigor. If scientism is a germ that infects economics, then Sargent and Sims were responsible for unleashing some of the most virulent strains."

Kling finishes by suggesting that how you view the Nobel depends on how you feel about the state of macroeconomics. On Oct. 17, Brad DeLong on his blog made it pretty clear how he feels. He reprinted a 2005 interview cited by Frydman and Goldberg in *Beyond Mechanical Markets* in which Sargent discusses "calibrations" in his models. As a technique, Sargent says, "calibration was intended as a balanced response to professing that your model, although not correct, is still worthy as a vehicle for quantitative policy analysis." DeLong is caustic about this attempt to save parts of models that seem to work, a sort of improvement by tweaking approach. "Yet that day of getting serious about building a model that could match the time series never came," snapped DeLong. "Moreover, I would say that it will not come." DeLong then went on to offer a description of the nonroutine nature of markets and the opacity of the future that could have come straight from "Beyond Mechanical Markets." (One wrinkle: DeLong and Krugman are both card-carrying subscribers to New Keynesianism, with its mechanical market models. DeLong did not tackle that.)

The toughest attack came on the biggest stage. On Oct. 19 in the *Financial Times*, John Kay entered the lists and quickly made it abundantly clear how he felt: "The Swedish Academy is brave but not very brave. It sensed that in present circumstances a prize to those who claim to understand the business cycle might encounter criticism. The public suspects that economists who specialize in this subject are of little use, and some professional critics agree. Willem Buiter [chief economist at Citigroup, formerly at the London School of Economics] has observed that the macroeconomics in which Prof Sargent is a central figure has been a 'privately and socially costly waste of time and other resources' and represented 'self-referential, inward-looking distractions at best.' " Whew.

It gets rougher. Kay goes on to witheringly discuss the "calibration" technique and the universal tendencies of rational expectations. Kay, with uncharacteristic sarcasm: "Rational expectations consequently fails for the same reason communism failed -- the arrogance and ignorance of the monopolist." Then he cites Frydman and Goldberg, mentions Hayek's critique of planning and wields the "market economy" against the free market apostles: "The market economy, unlike communism, can mediate different perceptions of the world, bringing together knowledge whose totality is not held by anyone. God did not vouchsafe his model to us."

Perhaps there will be a debate over markets after all.

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