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BIS hails a heretical revolution

Steve Keen

Alan Greenspan ignored the **Bank for International Settlement's** warnings to walk eyes wide shut into the GFC. But Treasuries are now under pressure to get it right, even with unorthodox models, and **the BIS is finding a broad audience.**

In the last four decades, there have been only a handful of central bank and Treasury papers that I thought genuinely added to human knowledge. The economic-oriented departments within governments have in general been even more dominated by neoclassical orthodoxy than academic departments - and for good, bureaucratic reasons.
If, by some accident, a non-neoclassical economist gets tenure at a university, then generally speaking, the university is stuck with him or her. The only way to get rid of him is to either drub up a misconduct charge, or to shut the entire department down. So academic economics departments have a core of dissidents within them, and even at the most conservative of institutions - since every now and then a neoclassical economist will spontaneously transmute into a critic (as American economist and economist growth theorist Robert Solow has done since 2000 with his increasingly vehement attacks on DSGE modelling - see for instance his 2003 speech Dumb and Dumber in Macroeconomics).

But if a non-neoclassical gets inside a central bank or Treasury, it's fairly easy to either relocate her within the government bureaucracy - "You'd be much happier in Social Services, don't you think?" - or to get her dismissed by a series of unfavourable performance evaluations.

That is changing now, I'm pleased to say - and partly because central banks and Treasuries now do have to perform. When times are good, politicians are happy to take the credit for the economy performing as well or better than their economic advisors expected, and the bureaucratic economists are allowed to do whatever they want to do - including purging critics within their ranks. But when the economy underperforms, and politicians have to wear the flak for predicting sunshine only to have economic rain ensue, then ultimately there's hell to pay. Academic economists can get away with failure, which is why new classical economists like Stephen Williamson can put out delusional posts about how "This is actually a relatively tranquil time in the field of macroeconomics".

The persistent failure of neoclassical models to get it right means that central banks and Treasuries are under pressure to get it right in future - even if that means trying what would once have been heresy. So right now, there is more innovation going on inside central banks and Treasuries than at universities. It may well be that, when change really comes to macroeconomics, it will come from these government departments rather than from academics.

One sign of this is a recent paper from the **Bank for International Settlements** - the central banker's central bank - entitled The financial cycle and macroeconomics: What have we learnt? , by **Claudio Borio**. It is the strongest call yet for macroeconomics - and central banks in particular - to, if not entirely abandon neoclassical DSGE models, then to develop a repertoire of non-neoclassical models as well. Its core paragraph is worth quoting in full here:
"Three themes run through the essay. Think medium term! The financial cycle is much longer than the traditional business cycle. Think monetary! Modelling the financial cycle correctly, rather than simply mimicking some of its features superficially, requires recognising fully the fundamental monetary nature of our economies: the financial system does not just allocate, but also generates, purchasing power, and has very much a life of its own.

Think global! The global economy, with its financial, product and input markets, is highly integrated. Understanding economic developments and the challenges they pose calls for a top-down and holistic perspective - one in which financial cycles interact, at times proceeding in sync, at others proceeding at different speeds and in different phases across the globe.

That's a paragraph I could have written - and this maintains a tradition at the BIS itself that goes back to when **Bill White** was the BIS's research director (from 1995 till 2008). White was an advocate of Minsky's 'Financial Instability Hypothesis' perspective on banking and finance markets, at a time when most central bankers - and Alan Greenspan in particular - were still besotted with the neoclassical 'Efficient Markets Hypothesis'.
I first realised that the BIS was something out of the ordinary when I read a 2003/4 paper written by Borio and White, expecting to feel my usual revulsion at yet another "the economy is self-equilibrating and finance is a benign force" monologue, and instead found myself nodding vigorously at what I read. So in that sense, nothing has changed: the BIS remains the exception that proves the rule.
The difference however is that, today, the BIS's word is being listened to. Central bankers are now also nodding at Borio and White's Minskian analysis, and encouraging staff to develop monetary, non-equilibrium models of the economy.

Before the crisis, **White**'s words fell on deaf ears - the deafest of all belonging to Alan Greenspan. Up to six times a year, Greenspan, along with virtually all the world's other central bank chiefs, attended meetings of central bankers in Basel. White was also a frequent participant in the US Federal Reserve's Jackson Hole conferences (as Der Spiegel pointed out in an excellent profile of White back in 2009, his paper with Borio was delivered at Jackson Hole in 2003), where Greenspan was an all-pervading presence. So very regularly, Greenspan would have to listen to White expound on why the markets were not stable, why private debt matters, and why a debt-deflation could occur in the near future.

I finally met Bill White at the INET conference in Berlin this year, and took the opportunity to congratulate him on his prescience and courage. He confirmed to me that when he made presentations at which Greenspan was present, "The Maestro" literally stared him down - using his personal power to intimidate anyone who might have expressed support for White's contrarian but, ultimately, devastatingly correct analysis.

So central banks walked blindfolded into this crisis, not because they had no idea that it could happen, but because they actively ignored warnings from right within their ranks that it would happen.
I get the feeling that this won't be allowed to happen again. **Borio**'s paper on how economists should model the economy is emphatic in a way that would have been impossible before the crisis.

All that's needed now is to develop the modelling methodology needed to recognise fully "the fundamental monetary nature of our economies". That's something that non-economists might think economists must already have, but unfortunately, they don't. Economists have long ignored money entirely in their mathematical models of the economy in the false beliefs that (a) banks, debt and money are too difficult to model and (b) they don't matter anyway.
I can't resist proving this point by citing what will go down as my favourite economist's quote from 2012: Paul Krugman's riposte to my paper for the Berlin INET conference in which I set out a method to build strictly monetary models of the economy. Krugman commented that: "Keen ... asserts that putting banks in the story is essential. Now, I'm all for including the banking sector in stories where it's relevant; but why is it so crucial to a story about debt and leverage?"

They are relevant for precisely the reasons that **Borio** sets out in his paper: "The financial system does not just allocate, but also generates, purchasing power, and has very much a life of its own". We need economic models which explicitly acknowledge that. As Bill White's successor acknowledged in the Der Spiegel article, the fact that neoclassicals had mathematical models that

predicted tranquillity ahead, while White's warnings were only verbal, played a role in his warnings being ignored:
"Ultimately, an economic model can only be defeated by an opposing model," says **BIS Chief Economist Stephen Cecchetti**, White's successor. "Unfortunately, we don't have a generally recognised model yet. Perhaps this partly explains why our warnings were less effective than would have been desirable."

That's where I come in. Over the last eight years, I've developed a simple means by which the economy can be modelled as a fundamentally monetary system - in contrast to the neoclassical attempt to model it as a barter system. This is now encoded in my simulation program Minsky, which is still in beta mode, but is now close to being usable for building medium-scale strictly monetary economic models.
Early in the New Year, I'll be starting the next steps to take Minsky from its current developmental level to an all-singing, all-dancing professional software program.

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Regards

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