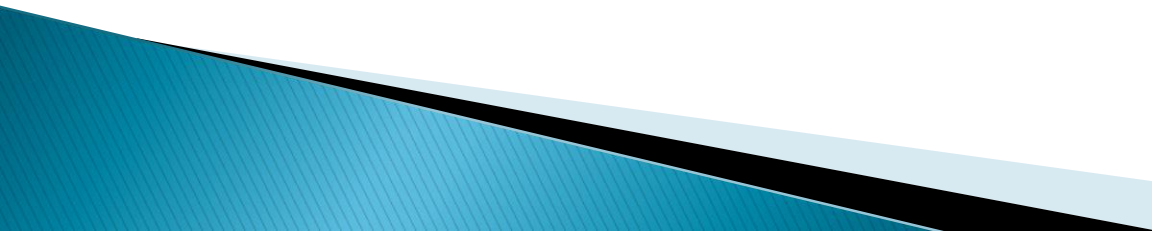


Modern Macroeconomics is NOT Science

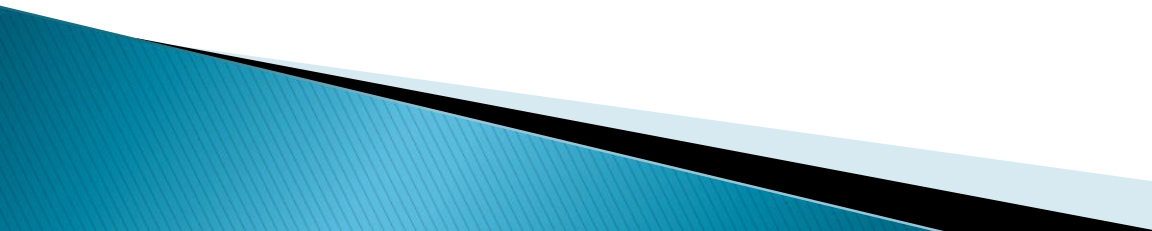
by William White

8th Annual Meeting of PBO's and IFI's
OECD Paris
11 April 2016

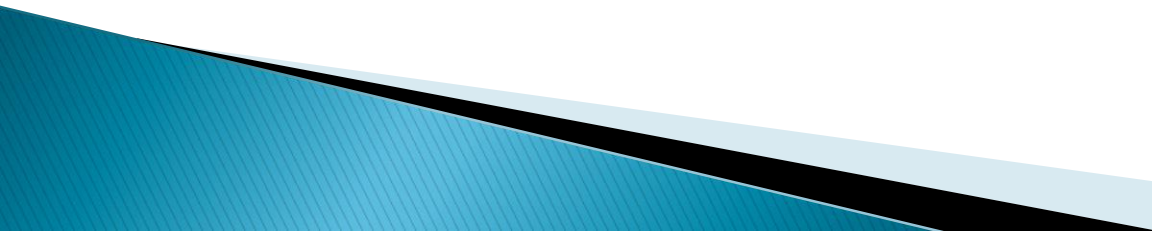
A profound “ontological” error

- ▶ Macroeconomists assume the economy is understandable and controllable – a “scientific” phenomenon
 - ▶ Yet philosophers believe that what you can understand depends on the “nature” of the system being understood
 - ▶ The economy today is too complex and constantly changing to be understood much less controlled
 - ▶ False beliefs can lead to unhappy endings; unconventional monetary policy and exchange rate systems
 - ▶ We are in a bad place and the worst is yet to come?
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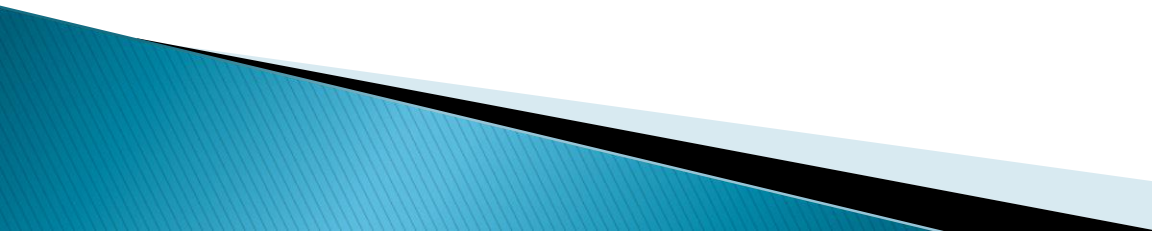
Compounded by unrealistic modelling assumptions

- ▶ Rigor and tractability in modelling have required.....
 - ▶ No money, no credit, no debt, no bankruptcies
 - ▶ Normality and certainty equivalence
 - ▶ Stable functions and stable probability distributions
 - ▶ Strong tendency to revert to equilibrium
 - ▶ Representative agent, rational expectations, etc.
- 


Proofs that modern macro can get it wrong

- ▶ Really bad things can not happen in theory, but they did in practice
 - ▶ IMF WEO forecast of Spring 2008 and eight years of forecast revisions
 - ▶ Fifty years of change in the theory and practice of monetary policy
 - ▶ Fifty years of change in the theory and practice of fiscal policy
 - ▶ And we are still adapting to an ever changing reality
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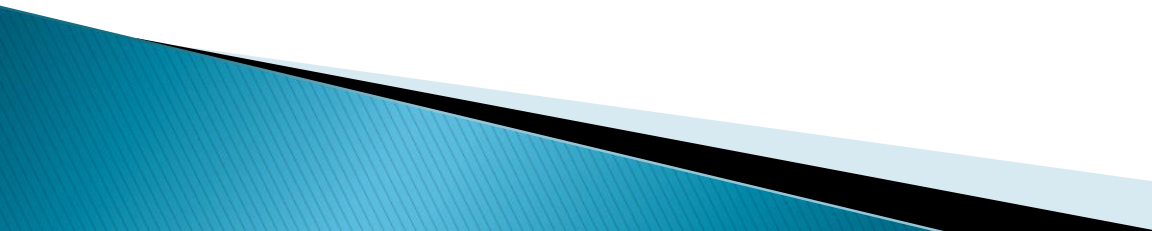
The role of IFI's and PBO's

- ▶ Enhancing fiscal discipline through public debate and transparency
 - ▶ Improving fiscal institutions and governance
 - ▶ Should IFI's also raise these fundamental analytical questions?
 - ▶ They imply the policy problem is not just risk but “imbalances” and Radical Uncertainty as well
 - ▶ Normal distributions, Power Laws and sometimes no distribution at all are all quite possible
- 


Fostering new thinking will not be easy

- ▶ The “need to believe” is hard wired by evolution
 - ▶ Paradigm shifts are hard in normal times
 - ▶ And even harder when old beliefs should be shocked by events
 - ▶ False beliefs that are “comforting” are particularly tenacious
 - ▶ As can be seen in the recent credit “boom” and ongoing “bust”
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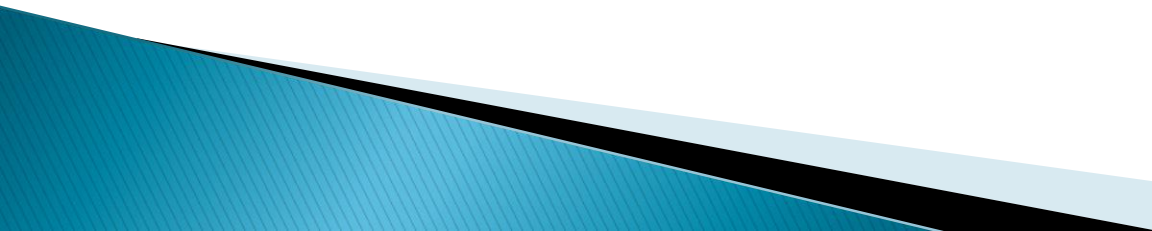
Where to from here? Embracing complexity?

- ▶ Many complex, adaptive systems exist in both nature and society
 - ▶ Why should the economy be almost uniquely different?
 - ▶ Characteristics of such systems fit the real world; regular crises, non forecastable outcomes, disconnect with trigger, constant evolution
 - ▶ Recognition of these characteristics also point to SIMPLE conclusions for economic policymakers; be prepared, minimax, focus on systemic issues, expect the unexpected
- 


Some specific lessons for IFI's in a credit "boom"?

- ▶ Use financial "imbalances" to estimate potential growth and the structural fiscal position.
 - ▶ Recognize contingent government liabilities given a subsequent "bust"
 - ▶ Use fiscal policy to lean against the boom, not least, fewer incentives to accumulate debt
- 

Some specific lessons for IFI's in a credit "bust"?

- ▶ Recognize that the fiscal position can deteriorate extremely rapidly
 - ▶ Recognize that the sovereign/banking nexus implies a vicious circle
 - ▶ History teaches that recovery can take a decade or more and that output losses may be permanent
 - ▶ Beware of using current low interest rates to help determine debt sustainability
- 

A worst case scenario?

- ▶ Big deficits and accumulating sovereign debt put pressure on central bank financing
 - ▶ Rising calls for “helicopter money” will exacerbate this trend
 - ▶ Recall Sargent and Wallace and “Some Unpleasant Monetarist Arithmetic”
 - ▶ And Bernholz’s historical examples of resulting hyperinflation
 - ▶ If the magic number is 40, Japan is already there.
- 

**GOOD LUCK
YOU MIGHT JUST NEED IT**

