Have economists gone mad?

As everyone knows, the past six months or so have seem tremendous turmoil in the world economy. The most obvious example of this is in financial markets. But overall output is also now falling sharply, in countries like Japan and Germany faster than at any time since the 1930s.

It seems obvious that these economies are *not* in a state of equilibrium, where everything flows smoothly. We are a long, long way away from any sort of equilibrium. And in the build up to the crash, we were out of sync in the other directions, with huge asset price bubbles, and unsustainable build ups of debt.

What does mainstream economics have to say about all this? The answer, contrary to what most people might very well say when prompted is not 'nothing'. It is even worse.

The American academic economics establishment is by far the most prestigious in the world. Career minded academics long to have an article accepted by one of their journals.

The American Economic Association has just launched a new journal. Its title? '*Macroeconomics*'. So this is exactly the place we should be looking if we want to know what academic economists are thinking about what is going on, how we got here.

Economists are notorious in the public mind for disagreeing with each other. But it turns out that, far from being riven by dissent, the academic profession believes it has reached a broad consensus. Indeed, the first issue carries an article by one of the world's leading macroeconomists, Michael Woodford, entitled 'Convergence in Macroeconomics: Elements of the New Synthesis'.

The first and most important part of the new synthesis is that 'it is now widely agreed that macroeconomic analysis should employ models with coherent intertemporal general equilibrium foundations'. What does this mean in English?

It means a) people and firms act in a rational, coherent manner b) they assess coolly and rationally the future consequences of decisions they take now c) the key driving force underlying the economy is a tendency for it to revert to equilibrium.

Yes, rub your eyes. The evidence is now so overwhelming that none of these statements are true that it is hard to see how they could even have been written.

But this madness is not just confined to university seminar rooms. These sorts of models – so-called 'dynamic stochastic general equilibrium models' – have become more and more influential in recent years in central banks and treasuries around the world. No wonder the policymakers received such bad advice!

A distinguished friend of mine went to a seminar in the Bank of England at the very height of the crisis last autumn, where many of their brightest economists sat down calmly discussing the finer mathematical points of general equilibrium models. He felt rather like Banquo's Ghost, except no-one paid the slightest attention to him at all.

There *is* a strong tradition in economics which emphasises *dis*equilibrium – Schumpeter, Keynes, Hayek. It certainly doesn't mean that everything they wrote was correct, far from it. But exactly the time that the world economy is in massive turmoil, economists who work in their tradition, including some recent Nobel Laureates, are becoming increasingly marginalised by the hardline academic mainstream.

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