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Cherished myths have fallen victim to economic reality

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The financial crisis continues to make victims. Not only people but also some of our most cherished ideas risk falling by the wayside. Take the hugely influential idea that financial markets are efficient. Its proponents told us that when financial markets are left free, they would work miracles. Savings would be channelled to the most promising investment projects, thereby boosting economic growth and welfare. In addition, these financial markets would spread risk around over a large number of participants, thereby lowering the risk of doing business, again boosting growth and welfare. In order to achieve these wonders, financial markets had to be freed from the shackles of government control.

The country that embodied these principles most was the US. Helped by the missionary zeal of successive American administrations and pushed by international financial institutions, country after country freed their financial markets from pernicious government controls, hoping to share in these economic wonders.

The credit crisis has destroyed the idea that unregulated financial markets always efficiently channel savings to the most promising investment projects. Millions of US citizens took on unsustainable debts, pushed around by bankers and other “debt merchants” who made a quick buck by disregarding risks. While this happened, the US monetary authorities marvelled at the creativity of financial capitalism. When the bust came a large number of Americans who had been promised a new life in their beautiful homes were told to move out. This boom and bust cycle cannot have been an example of efficient channelling of savings into the most promising investment projects.

The fact that unregulated financial markets fail to deliver the wonders of efficiency does not mean that governments should take over. That would be worse. What it does mean is that a new equilibrium must be found in which tighter regulation is reintroduced aimed at reducing the propensities of too many in the markets to take on excessive risks. The need to reregulate financial markets is enhanced by the fact that central banks, backed by governments, provide an insurance against liquidity risks. Such insurance inevitably leads to moral hazard and excessive risk taking. The insurer cannot avoid monitoring and regulating the behaviour of those who obtain this insurance.

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There is a second idea that is likely to become the victim of the financial crisis. This is the idea found in macroeconomic models that individuals are supremely well informed creatures. In these models that are now being used in central banks and universities, individuals understand the most complex intricacies of the world in which they live and they have no disagreement about this. All these individuals understand the same "truth".

If we have learned one thing from the credit crisis it is that individuals did not understand the "truth" and, it must be admitted, neither did economists. Individuals who sold the new financial instruments did not understand the risk embedded in these instruments, nor did the buyers. When the bubble started many interpreted the happy turn of affairs to be permanent and took on massive levels of debt that turned out to be unsustainable. When the bubble burst, they did not understand what happened and neither did most experts. Our world is one of a fundamental lack of understanding of the "truth".

But that is not the world of the macroeconomic models that are now in use in central banks. The world of these models is one of supernatural and God-like creatures for which the world has few secrets. These creatures can perfectly compute the risk they take and estimate with great precision how an oil price shock will affect their present and future production and consumption plans. They may not be able to predict each shock, but they know the probability distribution of these shocks. Thus the risk involved in financial instruments is correctly evaluated by individuals populating these models.

These superbly informed individuals want the central bank to keep prices stable so that as consumers they can optimally set their consumption plans with minimal uncertainty, and as producers they can set prices equal to marginal costs (plus a markup). If the central banks keep prices stable, these individuals helped by well functioning markets will take care of all the rest and ensure that the outcome is the best possible one. This is a world in which free and unfettered markets are always efficient.

This is also a world where individual agents cannot make systematic mistakes. Their consumption and production plans are optimal. They will never build up unsustainable debts. In the world of these macroeconomic models financial crises should not occur. And if they do, it cannot be because of malfunctioning markets. Governments who impose silly constraints on rational individuals are messing up things, and central banks who do not keep their promise to maintain price stability are the source of macroeconomic instability.

This intellectual framework helps to explain the single minded focus of many central bankers on inflation. Clearly, inflation is important and maintaining price stability is an important task of the central bank. It is not the only task, though. Financial stability is equally important. But this dimension is completely absent from the macroeconomic models now in use. In addition, since financial stability these days also depends on avoiding deep recessions, stabilising the business cycle should also be of the concern of the central bank.

Inflation in the euro area stood at 4 per cent in June. That is a problem.

But is it a more acute problem compared with the disequilibria in the financial markets and the banking sector? When the European Central Bank raised the interest rate two weeks ago it took the view that inflation is the most important problem we face. No wonder, the intellectual frame imposed on one's mind by current macroeconomic models said that inflation is the number one enemy.

There is a danger that the macroeconomic models now in use in central banks operate like a Maginot line. They have been constructed in the past as part of the war against inflation. The central banks are prepared to fight the last war. But are they prepared to fight the new one against financial upheavals and recession? The macroeconomic models they have today certainly do not provide them with the right tools to be successful. They will have to use other intellectual constructs to succeed.