Re-embracing Keynes

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Paul Krugman has a great article in the New York Times entitled "'How did economists get it so wrong'?'. Go read, I suggest. Some highlights are, however:

[H]ere's what I think economists have to do. First, they have to face up to the inconvenient reality that financial markets fall far short of perfection, that they are subject to extraordinary delusions and the madness of crowds. Second, they have to admit â€šÃ„Ã® and this will be very hard for the people who giggled and whispered over Keynes â€šÃ„Ã® that Keynesian economics remains the best framework we have for making sense of recessions and depressions. Third, they'll have to do their best to incorporate the realities of finance into macroeconomics.

He adds

Economics, as a field, got in trouble because economists were seduced by the vision of a perfect, frictionless market system. If the profession is to redeem itself, it will have to reconcile itself to a less alluring vision â€šÃ„Ã® that of a market economy that has many virtues but that is also shot through with flaws and frictions.

What's probably going to happen now â€šÃ„Ã® in fact, it's already happening â€šÃ„Ã® is that flaws-and-frictions economics will move from the periphery of economic analysis to its center.

I'm amused that some have criticised me for offering this analysis on this blog. They say I know nothing of economics as a result. Well, that's an argument. But Krugman has a Nobel prize in it. And he agrees that this is exactly the core problem.

And he criticises the Efficient Market Hypothesis Tim Worstall has declared so obviously true he cannot see how anyone can doubt it:

Until the crisis, efficient-market advocates like Eugene Fama dismissed the evidence produced on behalf of behavioral finance as a collection of "curiosity items" of no real importance. That's a much harder position to maintain now that the collapse of a vast bubble â€šÃ„Ã® a bubble correctly diagnosed by behavioral economists like Robert

Shiller of Yale, who related it to past episodes of “irrational exuberance” â€šÃ„Ã® has brought the world economy to its knees.

As Krugman notes:

Many economists will find these changes deeply disturbing. It will be a long time, if ever, before the new, more realistic approaches to finance and macroeconomics offer the same kind of clarity, completeness and sheer beauty that characterizes the full neoclassical approach. To some economists that will be a reason to cling to neoclassicism, despite its utter failure to make sense of the greatest economic crisis in three generations. This seems, however, like a good time to recall the words of H. L. Mencken: “There is always an easy solution to every human problem â€šÃ„Ã® neat, plausible and wrong.”

When it comes to the all-too-human problem of recessions and depressions, economists need to abandon the neat but wrong solution of assuming that everyone is rational and markets work perfectly. The vision that emerges as the profession rethinks its foundations may not be all that clear; it certainly won’t be neat; but we can hope that it will have the virtue of being at least partly right.

This is the economics we need.

It’s Keynesian (not, I stress neo-Keynesian or New Keynesian — they’re not Keynesian). It’s Keynesian.

Now let’s get on with it.