
Foreword

The crisis presented a challenge rarely seen in the field of economics, especially to those involved in economic policy, business decision-making, decision planning and macroeconomic analysis. It has also affected economists engaged in areas farther from daily practice, including those specialised in applied and theoretical economics. Theory had played an increasingly important role in economic policy decision-making during the years preceding the crisis. Besides theory, professionally sound empirical analyses had become an indispensable basis for policy advice. This was a welcome development, as academic soundness and the application of an extensively discussed analytical and decision-making framework widely accepted by the professional community can guarantee that decisions affecting the public good are made on the basis of the best possible knowledge available. With that in mind, policy-makers, including central banks, increasingly relied on the opinion of the most highly respected representatives of the profession, even supporting with the means available to them the enhancement and creation of such expertise by offering academic and training forums and publication opportunities for economists. Decision-makers and their staff advisers are often active members of the profession themselves, and the boundaries between practical and academic positions have become fluid.

Before the crisis, all of these progressive changes had contributed to the establishment of a theoretical and analytical framework of economic policies – in particular, monetary policies which appeared to resolve the macroeconomic and decision-making problems that had mired the profession in previous decades. First and foremost, the swings of the business cycle were successfully contained, and double-digit inflation was brought under control, first in developed economies and gradually in emerging countries as well. Many in the professional community believed that the larger issues of macroeconomic policy, especially those faced by monetary policy, had been essentially resolved for the foreseeable future.¹

As a result, the global financial crisis that erupted in 2007–2008 caught many professional economists off guard. Since then, numerous attempts have been made to explore the reasons that led to this professional fiasco and to determine what can be done to safeguard economies from turbulences of such magnitude in the future. At present, we are far from being able to draw all of the conclusions of this crisis. Full consensus on the theory's responsibility, if any, in the crisis is not expected to be reached for years to come. However, practising economists cannot wait until the formation of a new consensus. If a long-term perspective is taken and one examines the last great shock preceding the current crisis –

1 Lucas (2003), Bernanke (2004).

the global crisis of 1929–1933 – it is apparent that explanations for the causes of the crisis and the difficulties of recovery have changed over time. As evidenced in this context, the perception of the past changes with the accumulation of knowledge.

It is a specific aspect of economics that professional knowledge is not always amassed linearly. Indeed, in other academic disciplines, especially in natural sciences, we can reasonably assume that all new knowledge integrates and exploits previously accumulated expertise; while it eventually surpasses its predecessor, it still develops, for the most part, on the basis of what has come before. By contrast, in economics previous knowledge is much more often discarded, marginalised or even pronounced useless or preposterous, only to be rediscovered as new knowledge decades later. The case of Hyman Minsky is a good example. Apart from a handful of followers, he was nearly unknown to mainstream economics until he was suddenly propelled into the limelight during the crisis.² Minsky's example, however, offers some other lessons to consider as well. His most important theory – namely, that modern economies were inherently characterised by instability, and only the “Big Government” (i.e. fiscal policy) and the “Big Bank” (i.e. a stability-focused central bank) could protect it from extreme swings – was practically ignored, as the decades in which he conceived it happened to be a period of relative financial stability. This financial stability, however, was an exceptional period when, precisely as a response to preceding episodes of financial instability, in the 1950s and 1960s rather meticulous and all-encompassing financial regulations were enacted. At the same time, macroeconomic uncertainty, oil crises, fiscal deficits and simultaneously rising unemployment and inflation gave rise to the most severe problems. While macroeconomic policy concentrated on stabilising growth and prices, the restoration of financial stability was increasingly attributed to the natural, rational and equilibrium-oriented behaviour of the markets, whereupon external and internal regulations were considered to be superfluous and looked upon as an obstacle to the efficient functioning of markets.

For a long time, experience appeared to vindicate the opinion of those who claimed that as soon as macroeconomic stability – namely, moderate business cycles and price stability – was regained, financial sectors would be able to play their resource-allocating role efficiently and contribute to social welfare with sound operations. Paradoxically, however, precisely as Minsky had asserted decades earlier, macroeconomic stability created the right conditions for the accumulation of previously unprecedented financial imbalances. Evidently, economists have failed after all to learn from the experiences of previous, long-forgotten crises. One would have thought that it would be different this time around. Past fears, which had been very palpable as long as the experiences of the crisis were still fresh, started to fade away, and in the end they seemed like old wives' tales. The old set of decision-makers and market agents was replaced by new generations with

2 It is now called a “Minsky Moment” when over-indebted investors, spooked by an abrupt change in market sentiment, trigger widespread panic selling. The term was coined by the managing director of PIMCO Bond Fund and leading Fed commentator Paul McCulley to describe the 1998 Russian financial crisis and the default of LTCM.

different experiences that overrode earlier ones. In education, the history of economics and economic theories were relegated to the background.

If one asks “to what extent will post-crisis macroeconomics differ from pre-crisis macroeconomics?”, the following picture emerges. First and foremost, macroeconomic stability – in its narrower sense, limited to national income and price stability – will be seen as a necessary but insufficient condition for sustainable macroeconomic development. Likewise, financial stability will be considered as an indispensable condition, but one that requires special attention and effort to secure, as it does not materialise automatically as a mere “by-product” of macroeconomic stability.³

Future macroeconomics will certainly not push the financial sector to the sidelines of analyses as a passive intermediary system between savers and borrowers. The analytical framework should incorporate the reality that the financial sector has its own dynamics, and lending activity does not simply mean the allocation of previously accumulated savings. It means selecting an investment project that promises a return and finding the right form of financing in an environment where the decisions of creditors and borrowers are made in conditions of uncertainty. The economics of the future will acknowledge that it is not only the banking sector that is exposed to market frictions, uncertainty and other equilibrium-disturbing developments that threaten stability, but also – as learned from experience – financial markets.

The consensus economics of the future will almost certainly not handle imbalances and volatile fluctuations in the business and financial cycle as exogenous shocks but as the outcome of endogenous trends in which the real and financial sectors can both play their role. It is one of the lessons of the crisis that the financial sector, too, contributed to the overheating of the real economy and to the allocation of real resources among sectors that proved to be unsustainable over the long term. This poses a great challenge because macroeconomic and financial stability and the relationship between business and financial cycles, is not mechanical: from time to time, they may reinforce, offset or cancel out each other, depending on the circumstances.⁴

The basic assumptions of pre-crisis consensus economics have been widely criticised, including the hypothesis of rational expectations and representative agents. The assumption of rational expectations is useful in and of itself, but it led to the false conclusion that each agent understands the true and reliable model of macroeconomy and, consequently, its self-centred behaviour will ultimately serve the attainment of a general equilibrium. The crisis will put research in the limelight that does not assume that macroeconomic balance will be ensured by individual decisions *intended* to be rational, provided that

3 The concept of financial stability as a by-product of macroeconomic stability was conceived by Anna J. Schwartz, an economist who worked with Milton Friedman and co-authored some of his work. She was also among those who asserted that financial instability can primarily be linked to banks, while financial markets are less vulnerable.

4 Borio (2012).

actors are not otherwise hindered by “frictions” or “imperfections”. Individual decisions are made amid more or less uncertainty, the true model of the economy is not necessarily understood by everyone, and agents themselves are heterogeneous; consequently, the sum of individual rationalities does not by definition equal a general equilibrium. An old and well-known theory, the Keynesian “paradox of thrift”, is the biggest challenge of contemporary economic policy. If each agent, including the state and the rest of the world, follows individual rationality and increases its savings in an attempt to repay its debts and reduce indebtedness, it may happen that, because of the resulting weak aggregate demand, economic performance may lag far behind expectations and, eventually, no one’s original plans will be realised. Furthermore, the hypothesis of representative agents is overly simplistic because it does not merely assume the average behaviour of individual agents, but surmises that each individual agent *behaves identically*. However, numerous macroeconomic phenomena will be unintelligible if the heterogeneity of the actors is disregarded. Some decisions are made by a certain group of participants, and some decisions are made by others. Using the previous example, an economy will always include savers and investors. If these actors are not identical, it is easier to explain what is currently being seen – namely, that savings may significantly exceed investments overall. Based on the assumption of representative agents, one would expect that the purpose of savings is investment and, hence, more future consumption. This should not give rise to a protracted situation where savers resort to zero or even negative interest rates, while investment remains at low levels. In summary, consensus economics is expected to focus more resolutely on specifically macro-level correlations that cannot be simply deduced from the sum of micro-level individual behaviours.

The examples given above are far from being brand-new discoveries; in reality, they have been present in economic thinking for a long time. There were periods when they were a part of mainstream theory, but over time they were pushed to the sidelines of the profession, partly because the satisfactory functioning of economies did not pose a problem and partly due to technical reasons: incorporating them into the models proved to be too difficult. It can also be expected, however, that the future consensus will also incorporate new knowledge and relations that have limited antecedents in economics or none at all. They will emerge mainly as a result of the advancement of technical tools and available databases, which will facilitate the discovery of relations that could not be examined by the previously available toolkit. Such innovations include approaches capable of handling complex interactions based on the calculation-intensive, detailed analysis of massive databases. At present, we often have to resort to *a priori* assumptions because we simply do not have a sufficiently detailed database or the computing capacity required for analysing existing databases.

In a broader context, economics is expected to pay more attention in the future to issues which were once an integral part of economic thinking – until the professional

field narrowed the interpretation of its scope. Such issues include income or wealth inequalities and environmental problems. While these issues raise important social and ethical questions, it will become less and less possible to disregard their macroeconomic causes and consequences. Most economists have refrained from examining these issues for a long period of time, as they felt that in their analysis they would not be able to avoid value choices, which is against the spirit of “purely scientific” or “valueless” research. Experts who did tackle these problems could not expect undisputed recognition from the professional community, because these questions and the answers to them are potentially divisive, depending on individual value preferences. Finally, it is important to call attention to the most severe consequence of the crisis, which perhaps should have been mentioned at the very beginning: intolerably high unemployment, which unfortunately was well above long term average even before the crisis. Inevitable efforts to reduce unemployment to a minimum level will call for fundamentally new solutions in the future. We cannot expect the pressing problem of unemployment to be resolved automatically once economies have returned to a sustainable growth path.

In summary, a distinctively “macro” characteristic can be envisaged as emerging in the consensus macro-economics of the future, one with a more solid empirical foundation that is capable of addressing more complex relations between the actors in general and between the real and the financial sectors in particular. In this Foreword, I have only been able to touch on some of the significant changes expected to take place in economic thinking in the wake of the crisis. This new publication of the MNB is intended to foster a renewal of Hungarian economic thinking by offering a publication opportunity for those wishing to participate in this process. The MNB would like to facilitate the dissemination of international renewal efforts in Hungary and provide a forum for the relevant work of both in-house and external authors.

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