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IN DEFENCE OF ECONOMICS: A very short statement

Summary

This Econote breaks the pattern of past issues and rather than analyze and forecast asset markets, it outlines instead a number of arguments in defense of the science of Economics. Following the 2008-9 crisis, there has been a veritable outflow of criticism of Economics, and of economists, on the basis that the “science” and its practitioners did not predict, let alone prevent, the crisis. Our arguments are simple and are based on dispelling fundamental misconceptions of what Economics does, misconceptions which have led to these criticisms. This is not about how good and useful Economics is, but simply what it actually does and how it does it.

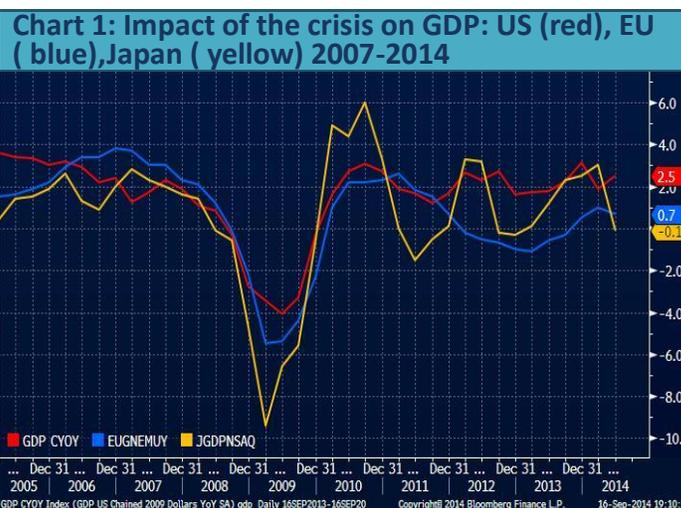
Investment Conclusions

The current received practice and tools of economic analysis will continue to provide ways of understanding how markets work and how to forecast them. Substitutes to the existing forms of market analysis which are based on the private ownership of the means of production, such as Marxism, have failed miserably not only in predicting what happened to capitalism but also have never offered a practical tool kit to help design and execute policies as well as analyze and forecast. Current economic practice is alive and well and will more than survive the 2008-9 crisis.

What Economics does

Economics analyzes the way people and societies allocate resources and decide **what, where, and when** to produce goods and services and **who** gets the fruits of production. These are the “4W” and they are the four inescapable and iron laws of allocating resources under constraints which all societies have to face. Whether societies are run by communes of peaceful hippies or blood-splattered extremists of all hues and convictions, none of these societies will be able to avoid these decisions. One big misunderstanding of current Economics is to associate it completely with capitalism and to claim that the current analysis of the economic interactions of people and societies is simply a defense of capitalism. Current Economics can be applied to ANY form of social arrangement and structure or any form of ownership of the means of production, whether communal or purely private. Current Economics can be used to analyze the allocation of resources in societies run by ascetic saints or totally cruel, heartless and selfish capitalist pigs. It is a value-free set of techniques. If it turns out that in the actual practice of the allocation of the means of production, markets tend to do the job more efficiently than central planning, then this has nothing to do with the science of Economics but with the final efficiency of

social structures. This is not the outcome of a conspiracy among economists to make markets appear preferable as a way to allocate resources, but a reflection of the realities of the world. Do not blame Economics for the failures of capitalism or socialism but blame the social system instead. The success or failure of Economics to forecast, focuses only on one aspect and uses of Economics and this, too, can be a misleading criticism.



Is Economics a “Science”?

This is the question where the critics of the current practice of Economics usually show their basic ignorance of what “science is and what it does”. The most common accepted approach to scientific method is to point that a method is scientific if it makes predictions, meaning patterns of behavior and/or outcomes, which can be the subject of empirical and quantitative testing by repeated and reproducible tests. The forecasts of any theory must be subject to refutation or confirmation by tests. An economic theory is not an abstract construct, but a simplified way of describing how a complex part of the world works and, on the basis of this understanding, how that part of the world will behave as circumstances change. Statements such as “that is OK in theory, but not in practice” simply betray ignorance

FACTBOX : Which economists to distrust and why

The 2008-9 crises threw up a veritable crop of mostly academic economists whose claim to fame is that they had, well ahead of the crowd, forecast the crisis. These economists now charge dearly for people to hear them repeat these claims, but in a different format.

Question: If these economist had forecast the crisis, why they are not now millionaires, having sold all the markets short and having made a killing for themselves and their universities? Why are they travelling the world earning relatively little as speakers? Why should we trust anyone who, clearly, did not trust their own forecasts and put their money where their mouths were ?

of the scientific method. A theory is not meant to reproduce reality but is an abstraction of reality. What “will not work in practice” should really mean that the predictions of the theory are not confirmed by repeated tests. Economics is eminently subject to this scientific method. It theorizes how the world works and its predictions, based on these theories, are then subject to refutation or confirmation by tests. Simple. But does Economics predict well how the world works? Why it did not predict the 2008-9 crisis? Forecasts and predications have three essential elements, **Direction** (up, down, the same), **Quantity** (X%, W amount etc) and **Time** (next Monday, next year, never). Witty forecasters suggest never to give all three components together ! So the

Chart 2: Impact of the crisis on stocks, S&P 500 (red) Eurostoxx (blue), Nikkei 220 (Yellow)



Source: Bloomberg

Economics stays relevant and useful

accuracy of the forecasts must be based on all three elements and not just one or two. So why did Economics not forecast the 2008-9 crisis? There were plenty of predictions that sometime in the future the expansion of geared property loans would end up in tears. This is just about the most commonsensical forecast one can make, short of “forecasting” that sometime next year it will rain ! The world is littered with crises which started with banks overextending loans to property and then crashing when the property sector crashed. Economics has plenty to say on that. Economics, however, did fail to predict **exactly when** the 2008-9 crisis happened but it had plenty to say before it happened, why and how it could happen. Could Economics have prevented the crisis? The answer is “No” as the Fed economic policy and US bank supervision could have been better and/or different, but Economics does not necessarily influence policy-makers. Politics and Economics do not intermingle well or at all, and perhaps this is for the better. There is also the issue that the crisis in the US is supposed to have caused a global banking crisis and, hence, all the worse that Economics did nothing about it. Ask China, India, Japan, Australia and all Asian economies if they had similar banking crises to that in the US. They did not ! The EU crisis was purely a sovereign crisis and had nothing to do with the US crisis but was made worse by it. Blaming that, too, on Economics simply shifts the target and also misses the point.