Failure of economics? Or the failure of (some) economists?

Why economists often make bad mistakes.

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Topics: The Economics of Post-Modernity: When Conventional Models Fail

Economic theorists are responsible for many economic failures in the developing world. (Credit: cwwc/Bigstock.com) (via: bit.ly)

It is widely known that economists failed to predict the Great Recession of 2008-09. It is less widely known that economists can never predict transitions from booms to recessions, and vice-versa, except by an accident: Econometric models have never correctly forecasted the turning points of the business cycle; every new recession in the last 200 years – as far back as annual economic statistics go – has come as a surprise (Krugman, 2009; 2012).

Very often we see a double standard in economic prescriptions. During the 1997 Asian crisis the US and international financial institutions – the International Monetary Fund and the World Bank – advised the governments of affected countries to (1) not increase government spending; (2) not expand the money supply; and (3) not bail out and/or nationalise banks. During the Great Recession of 2008-09, the US itself did exactly that. "Do as we say, not as we do" became the motto of the day.

To add insult to injury, economic theorists are responsible for many economic failures in the developing world, but cannot take credit for cases of successful development. Development thinking of the second half of the 20th century can hardly be credited for development success stories. It is difficult, if not impossible, to claim that either the early structuralist models of the Big Push, financing gap, and basic needs, or the later neo-liberal ideas of the Washington Consensus, which dominated the field from the 1980s on, have provided crucial input to the economic miracles in East Asia (Popov, 2010).

On the contrary, it appears that development ideas, whether they were misinterpreted or not, contributed to a number of development failures. The USSR and Latin America from the 1960s to the 1980s demonstrated the inadequacy of the import-substitution model through the debt crisis of the 1980s in Latin America and dead end of the Soviet-type economic model in the 1970s and 1980s. Elsewhere, every region of the developing world that served as experimental ground for Washington Consensus-type theories, from Latin America and Sub-Saharan Africa to the former Soviet Union and Eastern Europe, revealed the flaws of neo-liberal doctrine by experiencing a slowdown, or even a recession, in the 1980s and 1990s.

East Asian development successes stories – Japan, Hong Kong, Taiwan, Singapore, South Korea, Southeast Asia, and China – achieved high growth rates without much advice or significant credit lines from the IMF and the World Bank and Hong Kong, Taiwan, and China were not even members of the General Agreement on Trade and Tariffs/World Trade Organization for a long time. Economic miracles were manufactured in East Asia without much reliance on development thinking or theoretical background but rather through experimentation by 'strong-hand' politicians. The 1993 *East Asian Miracle* World Bank report admitted that non-selective industrial policy aimed at providing a better business environment – i.e., through education, infrastructure, coordination, etc. – can promote growth, but the issue is still controversial. Structuralists claim that industrial policy in East Asia equated to much more than creating a better business environment, in that it actually involved the state picking winners, whereas neo-liberals believe that liberalisation and deregulation should receive credit for the success.

Leo Tolstoy claimed in *Anna Karenina* that "happy families are all alike; every unhappy family is unhappy in its own way". This wisdom, however, can hardly be applied to respective countries' various development success stories. It appears that success stories in the world of development and transition differ widely.

It is not uncommon to come across contradictory statements on the reasons for economic success: Economic liberalisation and free trade are said to be the foundations of rapid growth in some countries, whereas other countries' successes are credited to industrial policy and protectionism; foreign direct investment, which is normally considered a factor contributing to growth, did not play any significant role in the development success of Japan, South Korea, and pre-1990s China. The privatisation of state enterprises, foreign aid, free trade, the liberalisation of the financial system, and democratic political institutions; all these factors, to name but a few, are usually believed to be prerequisites of successful development, but it is easy to point to success stories that are not associated with these factors.

Debate persists as to what is more important for economic development, the market or the state, and over the crucial factors behind economic fiascos; is it market failure or state failure? A dominant story among professional economists is that economic breakthroughs are achieved only due to a vital and vibrant private sector, which is dynamic and entrepreneurial, oriented towards innovations, and unafraid of risk-taking, whereas the state is clumsy, inefficient, even reactionary, and restrains private initiatives. Another story, however, is that of the entrepreneurial state: Mazzucato (2013) provides ample evidence that technological breakthroughs are due to public and state-funded investments in innovation and technology and that the private sector only finds the courage to invest after an entrepreneurial state has first made high-risk investments.

To cite an example, the breath-taking economic success of Japan, which transformed itself into a developed country in only two post-war decades, has conflicting explanations. In the 1970s, Japan's success was explained by the 'Japan incorporated' structure of the economy, i.e., the special relationships between: (a) the government and companies (led by the Ministry of International Trade and Industry); (b) banks and non-financial companies (the bank-based financial system); and (c) between companies and workers (through lifetime employment). After the stagnation of the 1990s, and especially after the 1997 Asian financial crisis, which also affected Japan, these same factors were widely labelled clear manifestations of 'crony capitalism' and held responsible for stagnation.

The reasons for the confusion over explanations and poor forecasting abilities of economic experts remain debatable. On one hand, there may be 'an engineering problem': An inability to make reasonable economic forecasts may be associated with a lack of knowledge and understanding of complex social processes, so there is a hope that better economic research will remedy the situation.

On the other hand, economics is a social science, and hence, interests of particular social groups matter a great deal. If social forces, especially those that control the media and/or the government, can benefit from particular policies even though these policies are harmful to other social groups and are not socially optimal, we might expect these policies to be presented and promoted as the best and most efficient.

There is a very important notion of Pareto-optimality in economics, defined as the best of all possible equilibriums, whereby the wellbeing of any single individual cannot be improved without the deterioration of the wellbeing of another individual. Public choice theory offers explanations as to why, in democracies with free media, decisions can be sub-optimal and as to what kind of political institutions and rules are required to ensure optimality. But it is the discipline of political economy that can answer the question of why these rules and institutions are not adopted.

References

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