

Summary of “The Emperor Has No Clothes”

James Morley

June 28, 2010

Much has been made of the failure of modern macroeconomics to predict or understand the Great Recession of 2007–2009. In the essay “The Emperor Has No Clothes”, I tackle the following questions:

- What is currently meant by “modern” macroeconomics?
- What is behind its failure?
- What can be done to rehabilitate its reputation?

Modern macroeconomics often takes something called the “Lucas critique” as its guiding principle. The idea is that the changing expectations of economic agents will confound forecasting and policy analysis based on macroeconomic data. This has motivated the development of micro-founded models of optimizing households and firms with “deep structural parameters”.

However, just as older versions of large-scale macroeconometric models failed to predict or even explain the “stagflation” of the 1970s, micro-founded “dynamic stochastic general equilibrium” (DSGE) models inspired by the Lucas critique have failed with the Great Recession of 2007–2009.

For DSGE models, economic mechanisms play less of a role in explaining the behavior of macroeconomic variables than is commonly believed. Instead, it is serially-correlated shocks to unexplained factors like technology that help mimic the data. Thus, much like a magic trick involving a rabbit and a hat, the underlying story is that serially-correlated shocks go into the model and serially-correlated variables come back out.

Although DSGE models have become more sophisticated in recent years, their “explanations” for events such as the Great Recession still boil down to unexplained changes in technology and willingness-to-work. Also, because DSGE models are often treated as literal descriptions of reality, their implications for policy are more assumed than freely estimated.

In terms of the large-scale macroeconometric models that DSGE models were designed to replace, the Lucas critique is sometimes regarded as a universal truth that denies their usefulness. However, it is an empirical question whether the macroeconomic relationships captured by these models are stable enough to help predict the effects of policy. Notably, estimates for key parameters in these macroeconometric models have been remarkably stable over time, while contemporary versions of the models have addressed the failures of the 1970s by including supply shocks and inflation expectations. Meanwhile, somewhat ironically, the “deep structural parameters” of DSGE models do not appear to be at all robust to changes in the policy environment.

To rehabilitate its reputation, modern macroeconomics should be more transparent about the extent to which policy implications are being assumed by a model rather than estimated. Explanations for events like the Great Recession should be more about the economic mechanisms of a model than the consequence of unexplained factors. Also, the usefulness of a model for prediction should be evaluated based on real-time forecasting performance. Above all, macroeconomists should be pluralistic in their analysis, including considering the insights of large-scale macroeconometric models and more narrative approaches such as the ideas of Hyman Minsky.