The crisis of macroeconomics, 2008-2009

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Just over a year ago, in September 2008, Lehman Brothers went bankrupt, spreading panic around the world. According to many analysts, given the dimension of the shock and its destructive propagation it was the 1929 Great Depression over again. But that opinion proved wrong. The world is already recovering.

A significant number of studies have already looked into the origins of the crisis in both market and government failure. Some economists have claimed that the development of macroeconomic theory since the 1980s has become sterile, disconnected from the real world, and totally useless in a crisis of such dimensions. Macroeconomists have been more concerned about the formalism of models than about their content, they charge. To what extent is that true?

Macroeconomics emerged with the publication of Keynes's General Theory in 1936. This classic work laid out the research agenda for the following half century. The Keynesian agenda led Hicks, Modigliani, Friedman, Tobin, Mundell, Fleming, and Phillips to build the architecture of the macroeconomic model in the late 1960s and was incorporated into undergraduate textbooks in the second half of the 1970s.

Two contributions by Lucas in the early 1970s signaled the culmination of the Keynesian agenda. The first, referred to as "rational expectations," allows the construction of consistent models in which people's expectations about future events play a crucial role. Until then, each person had a unique set of projections and the model produced another, completely different, set. Shortly after, rational expectations were entirely incorporated in Keynesian models, which promoted rigor, coherence, and empirical evidence.

The second contribution by Lucas is known in the economic literature as the "Lucas critique." It is a devastating analysis of models that were built on the Keynesian agenda. Why is that? The explanation is so simple that, once you understand it, you will ask yourself: why didn't I think of that before?

Let us imagine that you play soccer with your friends twice a week, and that there is always a team alongside waiting its turn to play. On one day, the organization is as follows: the winning team stays for the following match and the losing team goes home. On the other day, the matches are organized differently: For the first match, the winner criterion is applied. For the second and following matches, each team, winner or loser, gets to play only two matches. Is the behavior of the player different or is it the same on those two days? The answer is obvious: When the rules change, people's behavior changes accordingly.

Macroeconomic models are conceived to simulate economic policies, which are the rules of the game for consumers, workers, and businesses. Models where behavior does not change when economic policy changes must be regarded with caution. The Lucas agenda has attempted to build models in which the players make decisions that respond to the rules of the game. To what extent should Keynesian models be dismissed, and replaced exclusively by Lucas models? Empirical evidence does not provide a definitive answer so far.

Nevertheless, since the publication of the General Theory, which led to the Keynesian and Lucas agendas, macroeconomic theory has a better understanding of the dynamics of monetary and fiscal policies, even in situations like the recent crisis. The result of this developmental advance is that the 2008-2009 Great Depression did not happen.

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