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The random shock that clinched a brave Nobel Prize

By John Kay

Last week, Thomas Sargent was awarded the Nobel Prize for economics. The idea most economists would associate with him is “rational expectations”. But the citation does not use the term. It asserts that his methods have been adopted around the world, but gives little clue what these are, hinting only they can be applied to the study of macroeconomic relationships.

The Swedish Academy is brave, but not very brave. It sensed that in present circumstances a prize to those who claim to understand the business cycle might encounter criticism. The public suspects that economists who specialise in this subject are of little use, and some professional critics agree. Willem Buiter has observed that the macroeconomics in which Prof Sargent is a central figure has been a “privately and socially costly waste of time and other resources” and represented “self referential, inward-looking distractions at best”.

Needless to say, this is not how Prof Sargent sees it. In an interview published last year on the Federal Reserve Bank of Minneapolis website, he dismissed critics of the state of macroeconomics as too ignorant to deserve a response. Asked to explain how his research illuminated the recent crisis, he makes much of the finding that deposit insurance can halt bank runs. This insight is not, however, unique to Prof Sargent, who must be aware that the establishment of the Federal Deposit Insurance Corporation precedes the paper he cites by 50 years.

As the Nobel committee observes, “economic behaviour depends on expectations about the future and economists must consider how such expectations are formed”. In a brilliant linguistic coup, Prof Sargent and colleagues appropriated the term “rational expectations” for their answer. Suppose the economic world evolves according to some predetermined model, in which uncertainties are “known unknowns” that can be described by probability distributions. Then economists could gradually deduce the properties of this model, and businesses and individuals would naturally form expectations in that light. If they did not, they would be missing obvious opportunities for advantage.

This approach, which postulates a universal explanation into which economists have privileged insight, was as influential as it was superficially attractive. But a scientific idea is not seminal because it influences the research agenda of PhD students. An important scientific advance yields conclusions that differ from those derived from other theories, and

establishes that these divergent conclusions are supported by observation. Yet as Prof Sargent disarmingly observed, "such empirical tests were rejecting too many good models" in the programme he had established with fellow Nobel laureates Bob Lucas and Ed Prescott. In their world, the validity of a theory is demonstrated if, after the event, and often with torturing of data and ad hoc adjustments that are usually called "imperfections", it can be reconciled with already known facts – "calibrated". Since almost everything can be "explained" in this way, the theory is indeed universal; no other approach is necessary, or even admissible. Asked "do you think that differences among people's models are important aspects of macroeconomic policy debates", Prof Sargent replied: "The fact is you simply cannot talk about their differences within the typical rational expectations model. There is a communism of models. All agents within the model, the econometricians, and God share the same model."

Rational expectations consequently fail for the same reason communism failed – the arrogance and ignorance of the monopolist. In their critique of rational expectations, Roman Frydman and Michael Goldberg employ Hayek's critique of planning; the market economy, unlike communism, can mediate different perceptions of the world, bringing together knowledge whose totality is not held by anyone. God did not vouchsafe his model to us, mortals see the present imperfectly and the future dimly, and use many different models. Some agents made profits, some losses, and the financial crisis of 2007-08 decided which was which. Only Prof Sargent's econometricians were wedded to a single model and could, as usual, explain the crisis only after it had occurred. For them, the crisis was a random shock, but the occasion for a Nobel prize.

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