ECONOMICS, LABOR & BUSINESS

Model Students

THE SOURCE: "Macroeconomics After the Crisis: Time to Deal With the Pretense-of-Knowledge Syndrome" by Ricardo J. Caballero, ***NBER Working Papers***, Oct. 2010.

SINCE THE FINANCIAL PANIC IN the fall of 2008, many economists have embarked on some soul-searching: How did we miss this? But the failure to predict the largest economic crisis since the Great Depression doesn't bother MIT economist Ricardo J. Caballero. Major crises are "essentially unpredictable," he says. The big problem is not what economists don't know, but that they think they know more than they do. They aren't asking the right question: What policy advice can economists usefully give when so little is known?

Give credit where credit is due: At the periphery of the field, particularly at the intersection of macroeconomics and corporate finance, researchers are asking narrowly defined questions and producing "sensible but incomplete answers" about real-world events such as liquidity evaporation, bubbles, and contagion.

But the core of macroeconomics "has become so mesmerized with its own internal logic that it has begun to confuse the precision it has achieved about its own world" with accuracy in describing the real one. Economists have worked to fine-tune a model of great elegance, the "dynamic stochastic general equilibrium approach," with the hope that ultimately macroeconomics will be able to explain everything. But the economy is too complex for that.

Some may object that Caballero is being impatient, "that with enough time, we will arrive at an El Dorado of macroeconomics." He thinks that economists are just digging themselves into an ever deeper hole. But he's not saying that the model should be scrapped entirely, just that it should be recognized for what it is: a tool that can help us understand "equilibrium in a frictionless world."

In the real world, unlike in a model, people make economic decisions with limited information. Every now and then, something will give—for example, the defaults of the Penn Central Railroad in 1970 and Lehman Brothers in 2008—and people will panic. Such crises are not predictable, and events that cause a crisis one time may not do so the next. Some economists have argued that the oil price spikes in the 2000s caused fewer economic frictions than those of the 1970s because people had come to expect volatility and hence did not panic.

Economists can be most useful not by attempting to predict the future but by studying how to manage the inevitable uncertainty and anxiety of economic life, Caballero concludes. This research would enable them to devise policy options, such as different insurance schemes, that could help quell future panics.

EXCERPT

America's Surprising Export Centers

The 20 cities that most rely on export-related jobs include, not surprisingly, San Jose, Calif.; Seattle; and Portland, Oreg.—Asia-oriented hubs of high-technology innovation filled with young professionals, bike paths, and coffee bars that offer options of Euclidean complexity. But the list also includes places where the morning coffee run is more likely to McDonald's or Dunkin' Donuts: Hartford, Conn.; Rochester, N.Y.; Milwaukee; Greensboro, N.C.; and Toledo and Youngstown in Ohio. Only San Jose (at 22.7 percent) generated a larger share of its employment from exports than did Wichita, Kans. (22.3 percent), where a vibrant global sales network has developed around civil aviation powers such as Cessna and Hawker Beechcraft.

—**RONALD BROWNSTEIN**, editorial director of ***National Journal*** (Winter 2010)