

---

---

---

# Economists Speak

PRAKASH LOUNGANI

This book can make you fall in love with economics all over again. A collection of interviews with 16 eminent economists, it presents the attractive face of the field – one rediscovers an economics concerned with improving the human condition by putting to good use tools borrowed from disciplines as diverse as mathematics and psychology.

The book is a labour of love for William Barnett, the editor of the journal *Macroeconomic Dynamics* in which these interviews originally appeared between 1997 and 2005. Though the interviews were aimed at professional macroeconomists, much of the book is of broader interest. That is because these eminent economists, interviewed by their peers, are often able to describe their complicated work in simple terms, with modesty and humour, and enriched with anecdotes from their lives.

## Socialism and Shortages

Nobel Prize winner Robert Lucas recalls that when he was a little boy, in the 1940s, his father asked him if he thought there were any differences in the quality of the milk delivered by the five or six dairies that sent trucks to their neighbourhood. The young Lucas replied that the milk was probably quite similar. His father then told him “that under socialism only one truck will deliver to all the houses on each block, and the time and gasoline wasted in duplicating routes will be used for something else”.

Of course, in the 1940s, socialism seemed attractive by comparison to capitalism, whose allure had dimmed during the period of internecine economic warfare – the Great Depression – between the two world wars. But by the 1950s, the foundations of socialism had already begun to crack, as Hungarian economist Janos Kornai notes in his interview in this book: “My disappointment began in 1953...I began to recognise that the regime was economically dysfunctional and inefficient,

## BOOK REVIEW

**Inside the Economist’s Mind: Conversations with Eminent Economists** edited by Paul Samuelson and William Barnett; Blackwell Publishing, 2007; pp 456, \$ 31.95.

created shortages, and suppressed initiative and spontaneity”.

In his books, and in a 1979 article in the journal *Econometrica*, Kornai argued that “the problem of shortage plays a role similar to the problem of unemployment in the description of capitalism. The consumer constantly encounters shortage... Tens of thousands are waiting to get a telephone station, or to buy a car. The gravest phenomenon in consumption is a housing shortage which has grown into a pressing social problem.”

Because these “dysfunctional properties” of socialism were systemic, Kornai predicted that “the relaxed, half-reformed Gorbachev-type of system was incoherent, and subject to erosion.” But he admits in his interview here that he did not foresee “the speed and exact timing of it ... I hadn’t expected the collapse of the Soviet system as early as [1989-90]: It far exceeded all my expectations.”

He was not alone in being surprised. Only five years before its collapse, John Kenneth Galbraith wrote in *The New Yorker* about the enduring success of Russia after a trip there: “One sees it in the appearance of solid well-being of the people on the streets, the close-to-murderous traffic, the incredible exfoliation of apartment houses, and the general aspect of restaurants, theatres and shops... Partly, the Russian system succeeds, because, in contrast with the western industrial economies, it makes full use of its manpower.”

## Mending Macroeconomics

While shortages were bringing down socialism, capitalism was being mended – in part through a better understanding of how macroeconomic policies could help

economies close to full employment. At the end of the second world war, many economists had been worried that capitalist societies could not operate at full employment without a constant transfusion of heavy government spending. They predicted an economic collapse in the us when government spending returned to peacetime levels. That turned out not to be the case, as Nobel Prize winner Paul Samuelson admits in his interview: “By September of 1945, it was becoming obvious that oversaving was not going to cause a deep and lasting post-war recession. So then and there, I cut my losses on that bad earlier estimate.” The demonstration that full employment could be attained without a hyperactive fiscal policy helped restore some confidence in private markets.

The understanding and conduct of monetary policy also improved over the decades following the war, thanks in part to the work of Nobel Prize winner Milton Friedman. His analysis, conducted jointly with Anna Schwartz, convinced many that the us Federal Reserve had contributed to the depth of the Great Depression by stepping on the monetary brakes when it should have been stepping on the accelerator. Then, in the 1970s, the Fed committed the opposite mistake by flooding the global economy with liquidity and triggering a worldwide inflation. From these mistakes came a recognition of how to get things right. As summarised by Friedman in his interview in this book, “..you needn’t really worry too much about what was happening on the fiscal end, you just should concentrate on keeping the money supply rising at a constant rate.”

It took a fair bit of work however, both theoretical and applied, to translate Friedman’s idea of a monetary policy driven by rules rather than discretion into something that could be of practical use [see Arvind Subramanian’s 2004 article in the *Economic & Political Weekly* for the theoretical advances that helped]. On the applied side, former Fed chairman, Paul Volcker, one of the few policymakers interviewed in this book, played a big role. He says in his interview that he gave a speech in 1978 that “came to be labelled ‘practical monetarism’ because, for the

first time, I began rumbling about how... one could practically adopt some of these monetarist ideas...to make monetary policy more coherent and predictable.”

However, when the Fed tried strict money supply-based rules in the early 1980s, it was unsuccessful – the short-run relationship between the money supply and the economy was too unstable for the rules to be a good guide to monetary policy. Stanford University economist John Taylor – who shows up in this book as the interviewer of Friedman – helped devise “a simple and practical rule” to guide the conduct of monetary policy and also give observers a benchmark against which to measure the central bank’s performance [Loungani 2008]. Over time, the use of so-called Taylor rules, and the adoption in many countries of explicit or implicit inflation targeting regimes, has helped to improve the conduct of monetary policy.

How will monetary regimes evolve? The economists interviewed here take a range of views. Volcker states that he expects that 50 years from now there will be a single currency in the world. Much will depend on how the euro, which celebrated its 10th anniversary this year, fares. Volcker says he had predicted in 1989 that the euro would be successful: “It’s one forecast I got right so I remember it”. In contrast, Milton Friedman said he thought it “highly unlikely that [the euro] is going to be a great success”, in part because labour mobility within Europe was not very high. Friedman did however leave himself an escape clause by adding that if the adoption of the euro had “effect on trade, it may enable trade to substitute for the mobility of people”. Indeed, one of the reasons for the euro’s success thus far is said to be the tremendous increase in intra-European trade since its adoption. Friedman also correctly predicted in his interview, conducted in 2000, that “there’s very little doubt that within the next few years ...the euro will appreciate and the dollar will depreciate.”

**Financial Follies**

Though the conduct of macroeconomic policies has improved, the stability of the capitalist system is far from secure, as the ongoing financial crisis in many countries, triggered by the problems in the US housing sector, amply demonstrates. This crisis

comes only a few years after a dramatic correction in the prices of hi-tech stocks in 2000, a development predicted by Yale University economist Robert Shiller in his famous book *Irrational Exuberance*. In his interview, Shiller talks about why he rushed to finish the book: “I felt propelled by the market, and the collective delusions about the economy we were experiencing then, to write something against it. The book came out in March 2000, the very top of the market. ...I had a sense this market had to come to an end soon, and so I rushed to write that book.” Nobel Prize winner Franco Modigliani was also prescient in stating in his 1999 interview that “the stock market in the United States is in the grips of a serious bubble”.

Interestingly, Volcker – who has spent a lifetime working in US financial circles – also expresses anxiety about the stability of the financial system. In his interview in this book, conducted in 2000, he says: “I’m very sceptical of the effort of the banks to develop so-called ‘modern’ risk management approaches based on some theoretical modelling by mathematicians who never saw a financial market...The whole concept rests on the idea of normal distribution curves but there ain’t no normal distribution when it comes to financial crises.”

But despite their anxiety about financial instability, the economists interviewed

here do not advocate a very heavy-handed role for the state. Shiller says that financial institutions have to be designed the way airplanes are, so that they “do not go wildly off course when there is a minor pilot error” but that “overall, expanding markets is the right thing to do”. Volcker agrees that “...there is a role for supervision and a role for some sense of giving the market a broad sense of direction. But you can’t get into the details of the markets, you can’t attempt to manage it in a bureaucratic way, because it just doesn’t work.” And Nobel Prize winner Robert Aumann reaches way back into history, noting that “...the Talmud says that the authorities must appoint inspectors to check the accuracy of the weights and measures used by marketplace vendors, but *not* to oversee prices.”

**Role of Rationality**

The book is not concerned just with the broad issues of choice of economic systems, the respective roles of market and the state, and financial instability; for professional economists, it also provides a rich discussion of many topics that might be considered shop talk. One important illustration of this is the discussion of how best to model how people form their expectations about the future and the validity of the assumption of rational behaviour. Lucas and others in the 1970s developed the

**Gokhale Institute of Politics and Economics**  
(Deemed to be University)  
Pune – 411 004

**Advertisement (Advt. No. 17.7.1.E/07/2008)**

Applications are invited in prescribed form for the following teaching and non-teaching posts to be filled in the Institute.

1. Professor	1 (Open)	Economics/Sociology/Political Science/ Other Social Sciences
2. Reader	2 (1SC, 1 Open)	Economics and other Social Sciences
3. Lecturer	3 (1SC, 2 Open)	Economics and other Social Sciences
4. Research Associate	2 (1SC, 1 Open)	Economics and other Social Sciences
5. Research Assistant	2 (1SC, 1 Open)	P.G. in Social Sciences/Social work
6. Professional Assistant	1 (Open)	P.G. in Social Sciences/ Social Work/Computer Science
7. Data Entry Operator	2 (1SC, 1Open)	Graduate with recognized diploma/ certificate in computer applications
8. Library Attendant	1 (Open)	SSC Pass with local language
9. Attendant	1 (Open)	8 <sup>th</sup> class pass with local language

These appointments will be made for a period of one academic year, likely to be continued for another four years subject to (i) receipt of grants from the UGC and the State Government after completion of one year and (ii) satisfactory performance of the selected candidates.

The reserved posts will be filled in by candidates belonging to that particular category only and domiciled in the state of Maharashtra. Due consideration for reservation for persons with disabilities would be given.

The prescribed application forms and information regarding the required minimum qualifications and other particulars can be downloaded from our website ([www.gipe.ernet.in](http://www.gipe.ernet.in)), and they are also obtainable free of cost from the Registrar of the Institute either personally or by sending a self-addressed envelope. The last date for the receipt of the application is **August 14, 2008.**  
**Offg. Director**

concept of rational expectations, which assumes that people's expectations of, say, inflation, are consistent with the model that the economist writes down to explain inflation. So if inflation depends on some aggregate demand and supply factors, people's expectations of inflation should depend on their predictions of those factors.

While this is a logically elegant way of describing how expectations are formed, many of the economists interviewed here express doubts about the realism of rational expectations, particularly over the short run. Friedman agrees that rational expectations is correct to assume that "people try to predict what is going to happen tomorrow", but in practice "there is always going to be a lag in expectations catching up". Samuelson says that he tends to agree with only a weak form of rational expectations: "Fool me once. Shame on you. Fool me twice. Shame on me." Shiller argues that "there ought to be more recognition of the limited ability of people to calculate [and] their tendency to use rules of thumb ...".

Aumann provides some of the most interesting discussion of the role of rationality in economics. He argues for what he calls "rule rationality": "the basic premise is that people grope around. They learn what is a good way of behaving. When they make mistakes they adjust their behaviour to avoid those mistakes. It is a learning process, not an explicit optimisation procedure...Rule rationality means that people evolve rules of behaviour by which they usually act, and they optimise these rules. They don't optimise every single decision".

At the same time, Aumann is dismissive of behavioural economics, which he feels goes too far in challenging the notion that people behave rationally and respond to incentives. He says that the laboratory settings used in reaching these conclusions often do not replicate the repeated real-world interactions that people go through in life. He then adds words that will be music to any economist who has played around with real-world data: "...true behavioural economics does in fact exist; it is called empirical economics. This really is behavioural economics. In empirical economics, you go and see how people behave in real life, in situations to which they are used. Things they do every day...Empirical

economics shows that people do respond very precisely to economic incentives".

Aumann concludes with the important distinction that what economists study is not necessarily what they advocate: "...studying selfishness is not the same as advocating selfishness...Game theory says nothing about whether the 'rational' way is morally or ethically right... If we want a better world, we had better pay attention to where rational incentives lead."

### Elements of Eminence

The interviews reveal some common traits among these eminent economists. One superficial one is that they are all white males. Those seeking to hear from or about economists of the other gender and other hues will have to wait until the planned second volume of these interviews or look in other sources. An interesting set of profiles of eminent Indian economists – Jagdish Bhagwati, Manmohan Singh, I G Patel, Krishna Raj, and others – can be found in Deena Khatkhate's recently published book, *Ruminations of a Gadfly*.

Looking beyond the superficial, three other traits stand out. First, many of these economists have over the course of their professional lives been able to strike a balance between working on fairly abstract problems and very practical ones. The practical problem-solving often came about because many of the older economists helped their defense establishments during the second world war and the cold war. Aumann, for instance, worked on the abstract mathematical problems, but also used game theory for very practical matters like how best to defend a city from a squadron of aircraft, most of which were decoys but a small percentage carried weapons. He was also one of a group of game theorists involved in the arms control negotiations with the Soviet Union in the 1960s – this followed the Cuban missile crisis during which, Aumann says, us president Kennedy was influenced by the game-theoretic school in international relations, which was prominent at the time.

Modigliani provides a wonderful illustration of a peacetime use of economics to solve a practical problem. In 1975, in the middle of the oil crisis, the Italian labour demanded a new type of cost-of-living adjustment "in which an x % increase in

prices would entitle a worker to an increase in wages not of x % of his wage but of x % of the average wage – the same number of liras for everyone! And the high-wage employers went along with glee!" Modigliani wrote a couple of indignant articles trying to explain the folly of this policy and helped to eventually roll it back, though not before its use caused several years of economic turmoil.

Among the younger economists, Shiller stands out as one who has contributed to both theory and practice. He helped launch the field of behavioural finance [Loungani 2004] but has also run a successful business, Case-Shiller-Weiss, which provides sophisticated house prices indices that are proving useful in tracking the course of the present housing crisis. Shiller thinks that "for an academic economist, it is a good thing to run a business", adding that he would "encourage more economists to do practical things, like write patents", rather than proposals for academic grants.

### Truth and Modesty

A second common feature that emerges is integrity – these economists have conducted their work to seek the truth rather than from a desire to be interesting, provocative or prove ideological points. Samuelson says that "my aim is not to be interesting but rather, as best as I can, not to be wrong". Lucas, when asked if his famous result that the welfare costs of business cycles is small was merely an attempt to be provocative, responds: "I don't write things I don't believe in just to be provocative! Those estimates may be too small, but if so, it is an honest mistake." And even Milton Friedman, often portrayed as rigid in his views, forswears that those views were formed by his reading of the evidence: "I believe that I can honestly say that I never reached a judgment about monetary or fiscal policy because of my belief in free markets ... If fiscal policy had deserved to play a much larger role, that would have shown up in the data."

These interviews thus show, in Shiller's words, that "our profession indeed includes a lot of open-minded people, who really look at the evidence, even though their own published work may not make obvious to readers the breadth of their understanding and personal desire to pursue the truth".

A third trait is modesty. These economists are modest about their achievements and influence, they play up the contributions of their peers, and they often emphasise the role that luck has played in their lives. Once suspects that these traits may have been less conspicuous when they were younger, but they are nevertheless welcome. Modigliani, speaking of the famous Modigliani-Miller theorem, now wonders “whether it deserves two Nobel prizes”. Stanford economist Thomas Sargent, asked about his contribution to Lucas’s famous critique of econometric policy evaluation, jokes that he once retrieved a draft of it when Lucas had left it behind at a conference: “I mailed the manuscript back to Bob. So, yes, I contributed to the critique.”

In a similar vein, Jacques Dreze says that “...perhaps my main contribution to economics has been to sire Jean Dreze, who has contributed very positively and significantly to development economics, and nowadays plays an active role in promoting a form of social security in India.”

Stanley Fischer, currently Israel’s central bank governor, says that when he returned to academia after a stint as the World Bank’s chief economist he was expected to revolutionise the study of development at Massachusetts Institute of Technology. But, he adds, “I didn’t. The younger generation, which came not so long after, including Abhijit Banerjee, probably did.”

Friedman pooh-poohs the notion that he wielded great policy influence on us presidents, saying that they “would have acted as they did if they had never seen me or heard from me”. He also dismisses as grandiose the view that he had a well-thought out agenda for restoring the luster of capitalism and free markets: “...people have a tendency to attribute to me a long-term plan; they think I must have planned this campaign. I did no planning whatsoever. These things just happened in the order in which they happened to happen. And luck plays a very large role, a very large role indeed.” Samuelson also talks about his “incredible luck” in stumbling upon economics

at a time when the subject had “myriads of challenging open problems...I once described this as being like fishing in a virgin Canadian lake. You threw in your hook and out came theorem after theorem.”

And speaking of fishing, one other common trait of these eminent economists seems to be that they like to fish. The book has several interesting photographs, quite a few of which show these economists with the fish they have just caught. Perhaps fishing is an activity that involves practical problem-solving and yet allows time for deep thinking about abstract economic matters.

Email: PLOUNGANI@imf.org

#### REFERENCES

- Khatkhate, Deena (2008): *Ruminations of a Gadfly: People, Places, Perceptions*, Academic Foundation, New Delhi.
- Loungani, Prakash (2004): ‘Figuring Out Financial Markets: More Psychology than Economics? Interview with Robert Shiller’, *IMF Survey*, April 12.
- (2008): ‘The Quest for Rules: A Profile of John Taylor’, *Finance and Development*, March, Vol 45, No 1.
- Subramanian, Arvind (2004): ‘2004 Economics Nobel: The Two Insights of Kydland and Prescott’, *Economic & Political Weekly*, October 30.