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# Is Macroeconomics Believable?

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**I**n January 1997, the annual convention of the American Economic Association included a session entitled “Is There a Core of Practical Macroeconomics That We Should All Believe?”<sup>1</sup> Macroeconomics, which is concerned with large-scale, or aggregate, magnitudes such as total production and employment, is one of two grand divisions of economic theory, the other being microeconomics—the study of individuals, firms, and markets. The convention session highlights the profound distress that macroeconomics finds itself in today. Imagine the American Chemical Society holding a convention session to consider whether organic chemistry has a believable core, and you will have some idea of the troubles of an academic discipline whose practitioners aspire to offer guidance to central banks, national treasuries, and heads of state. How could a field that held so much promise after World War II have reached the point where its own finest practitioners are called upon to defend the proposition that it has a believable core?

## The Individual and the Aggregate<sup>2</sup>

Any account of modern macroeconomics must begin with John Maynard Keynes, who is clearly its founder. Keynes’s only formal education in economics consisted of several weeks of study under the tutelage of Alfred Marshall, the father of microeconomics as it is still taught to undergraduates today. Very much the Victorian, Marshall believed that frugality, rationality, and honor were virtues that society should

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1. See Blanchard 1997, Blinder 1997, Eichenbaum 1997, Solow 1997, and Taylor 1997.

2. Some of the comments in this section were previously made in Bolch 1995.

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encourage.<sup>3</sup> Like Adam Smith, Marshall viewed the free-market system as a superior setting for the development of these virtues.

Keynes, however, was almost maniacally bent on overthrowing both Victorian ethics and the view that economic systems are best left to self-regulation. As Robert Skidelsky has shown in a massive two-volume biography (1983 and 1994) and Gertrude Himmelfarb (1985) also has noted, the personal life of Keynes and fellow cognoscenti in the Bloomsbury Group went beyond mere deviance. In an attempt to overthrow the morals of his Victorian predecessors, Keynes and the other denizens of the Bloomsbury Group engaged in an almost unbelievable series of sexual permutations and combinations, the details of which Skidelsky has explored ad nauseam.

While Keynes rejected the macroeconomics of Marshall and the morals of the Victorians, he adhered to the technical utilitarian framework of Marshallian microeconomics. This peculiar mixture of technical Marshallian microeconomics and Keynesian macroeconomics has become today's mainstream economic thought. Julie Nelson and Steven Sheffrin (1991) have pointed out that this combination has produced a kind of schizophrenia in modern economic thought: Marshallian microeconomics lends itself to advocacy of market freedom, whereas Keynesian macroeconomics lends itself to advocacy of government control.

Many other dualisms stem from the belief that the economics of aggregates differs from the economics of individuals. One example is the "paradox of thrift," which Paul Samuelson's best-selling textbook foisted upon several generations of economics undergraduates. According to the paradox, individual saving is "good" but aggregate saving is "bad." I will return to duality problems of this kind. For now it suffices to note that finally, the paradox of thrift has vanished from most undergraduate textbooks.

Why should macroeconomics and microeconomics differ? One of the least cited rationalizations is that crowds often exhibit manias and madness not found in individuals (Kindleberger 1978). This idea that the whole somehow differs from the sum of its parts, a notion imported into economics from Gestalt psychology, is ingrained in the thinking of many practicing macroeconomists. But even if it is true, it does not entail that aggregate behavior is best understood by the study of an aggregate, as opposed to the study of the constituent parts of the aggregate. As Ludwig von Mises (1963) wrote,

The road to the performance of great things must always lead through the performance of partial tasks. A cathedral is something other than a heap of stones joined together. But the only procedure for constructing a cathedral is to lay one stone upon another. (45)

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3. See Marshall [1890] 1920, especially chapter 1, in which he discusses the subtle interactions of ethics, religion, and economics.

A second apology for the macro-micro separation likens economics to physics. If physicists find it necessary to appeal to one theoretical structure when attempting to explain subatomic events and to another when dealing with the relatively large-scale phenomena of gears and levers, then why not economists likewise? Many economists find this explanation more than a little pretentious, recognizing that some economists lust to be like physicists in that they suffer from cases of severe  $\pi$ -envy (Mirowski 1989). More to the point, physicists themselves strive, perhaps in vain, for unified theories that will eliminate what most theoretical physicists regard as an unattractive scientific condition.<sup>4</sup>

A third rationalization has to do with data stability. It is a fundamental principle of statistics that arithmetic means vary less than the individual data points from which they are constructed. But for critics such as F. A. Hayek, aggregates and averages are pseudoscientific constructs that mask the behavior of the individuals they comprise. For example, it is not possible to study the competitive process or entrepreneurial activity by the use of aggregates, because such aggregates mask the all-important interactive elements in those processes.<sup>5</sup> Mises (1963) put it even more harshly:

An ideal type has nothing at all to do with statistical means and averages. Most of the characteristics concerned are not open to numerical determination, and for this reason alone they could not enter into a calculation of averages. But the main reason is to be seen in something else. Statistical averages denote the behavior of the members of a class or type, already constituted by means of a definition or characterization referring to other marks, with regard to features not referred to in the definition or characterization. The membership of the class or type must be known before the statistician can start investigating special features and use the result of this investigation for the establishment of an average. (60)

This profound skepticism by members of the Austrian school such as Mises and Hayek contrasts with the hopes of statisticians, for literally centuries, that the relative stability of aggregates would allow the detection of social laws that could not be deduced from the chaos of disaggregated data. For Karl Marx and many of his sympathizers, the use of Adolph Quetelet's doctrine of the "average man" offered hope for the definition of a uniform standard of labor, which was needed for a defensible inter-

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4. Skidelsky (1994, 487) points out that Keynes identified himself with Albert Einstein, whose theory of relativity gained acceptance after it passed its first critical empirical test by predicting the effect of gravity on light. Keynes's theory, on the other hand, gained acceptance after it failed its first critical empirical test, which pertained to the behavior of wages over the course of the business cycle. See my entry on Lorie Tarshis in Cate 1997, 598.

5. Hayek was often contemptuous of the use of statistics in general, as in his story of the Spanish Schoolmen who decided that the price of a good depended on so many things that it could be known only by God (Hayek 1979).

pretation of the labor theory of value (Porter 1986, 66 ff.). Averages seem always to be the darling of socialist calculation, because averages are such great levelers: they are often (but incorrectly) interpreted as if they were constants.

Many economists consider the foregoing criticism of aggregates excessive. Mises (1978) himself softened his attack on the use of aggregates and averages when they served the purpose of “helping to open the eyes of the people” (89). Nevertheless, the criticism serves as a constant reminder of the tenuous nature of the aggregates themselves and of the falsity of the view that policies aimed at altering some aggregate necessarily strike everyone in the aggregate equally.

It is interesting to speculate on the role that Keynes’s moral and ethical beliefs played in this micro-macro bifurcation. As repulsive as the behavior of the Bloomsbury Group might seem to most people, Keynes and his crowd rationalized their behavior as pathbreaking experimentation that an elite needed to carry out in order to broaden the moral perspective of the masses. Like most people, Keynes found the aesthetic liberation from common morals to be heady stuff. He wrote: “It was exciting, exhilarating, the beginning of a renaissance, the opening of a new heaven on earth, we were the forerunners of a new dispensation, we were not afraid of anything” (quoted in Himmelfarb 1985, 39).

Paradoxically, although Alfred Marshall’s work rested on a solid moral foundation, he was most responsible for defining economics as a discipline separate from the academic study of ethics, because he removed the study of economics at Cambridge from the study of history and moral sciences. His student Keynes, at least in his early career, adopted the philosophy of G. E. Moore ([1902] 1988), which identified the “good” as nonnatural and beyond definition. Indeed, for Moore, aesthetic enjoyments include the greatest “goods” one can find.<sup>6</sup> And, of course, in the days of Keynes’s youth, it was commonly assumed that aesthetic enjoyment lay within the purview of the upper class. Yet, as Alasdair MacIntyre (1981) points out, intuitional ethical systems such as Moore’s afford no grounds for agreement—what is ethical for you need not be ethical for me, and no method exists for resolving our disputes. Such systems invite people to do whatever they please. When carried over into scientific investigation, they foster a type of economics that is both elitist and ad hoc.

Keynes’s elitist attitude toward the economic system is well documented by Allan Meltzer (1988) and Joseph Salerno (1992) and in numerous writings by Hayek, who knew Keynes personally and respected his intellect. In the main, Keynes argued that fluctuations in output placed an excessive burden of uncertainty on potential investors, which would tend to reduce investment and hence economic growth. Further, private action could not remove this burden, so the state must do so. In the view of

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6. Himmelfarb (1985, 39) correctly notes that Moore did state that whenever one is unsure of the long-run consequences of an action, the existing moral rules should be followed. Clearly, Keynes rejected this advice.

Salerno (1992),

Keynes came increasingly to believe that the sins of “avarice, usury and precaution” (which, in the language of the *General Theory*, became “liquidity preference, interest payments to the *rentier*, and saving”), not only were evil . . . but were at the root of the economic instability and stagnation of the present age of economic scarcity and therefore must be expunged by the State. (29–30)

But what person or persons representing “the State” would carry out this grand improvement? Keynes was certainly no fool; he recognized the dangers inherent in his ethics in the hands of others, especially in his famous letter to Hayek on the occasion of the publication of Hayek’s *Road to Serfdom* (1944). In this book, Hayek mounted a devastating attack on the idea of a managed economy and commented at length on why only the “worst” of people would come to manage command-and-control economic systems. Missing the point completely, Keynes indicated in his letter to Hayek that although he agreed with most of what Hayek had written, he did not regard the danger as very great if control were restricted to the “right people.”<sup>7</sup>

Yet control by the right people has a long and discredited history. Nathan Rosenberg and L. E. Birdzell (1986) argue that China lost its early economic lead over the West in large part because the mandarin class controlled the economy more efficiently than Western bureaucrats did. People educated in the liberal arts tend to despise the messiness of business and markets, their lack of aesthetic merit. The Chinese bureaucratic class, chosen by a ruthlessly efficient merit system and honed to a fine edge in a magnificent educational program, took charge of regulating a splendid (for its day) economy. They produced, in their eyes, an aesthetically pleasing economic system. More remarkable in our eyes, they brought economic progress to a halt.

## The Long Run and the Short

Nobel laureate Robert M. Solow (1997) writes:

One major weakness in the core of macroeconomics as I have represented it is the lack of real coupling between the short-run picture and the long-run picture. Since the long run and the short run merge into one another, one feels they cannot be completely independent. (231–32)<sup>8</sup>

To consider a concrete example of this lack of coupling, suppose that politicians

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7. Some marvelous comments by Hayek on Keynes can be found in the film “F.A. von Hayek,” Films for the Humanities & Sciences, Inc., Princeton, N.J.

8. Yet in his entry on Trevor Swan in Cate 1997, Solow writes: “It serves also as a reminder that one can be a Keynesian for the short run and a neoclassical for the long run, and that this combination of commitments may be the right one” (594). Will the real Robert Solow please stand up?

in the United States wish to finance some politically popular scheme but are unwilling to levy the taxes to pay for it. In that case, if the Federal Reserve System obliges, there is no absolute constraint on its ability to finance the spending by expanding the stock of “outside” money (currency plus commercial-bank reserves). The Fed can simply purchase government debt, rebate the interest to the Treasury, and expand the government’s short-term command over resources.

Over the long run, such monetary policy will prove to be highly inflationary; therefore, even though it may please the public in the short run, it will displease them in the long run. By the time the true inflationary costs of the borrowing are known, however, the current politicians may be gone or may have created a scapegoat to blame for the inflation.<sup>9</sup> Thus, the only real restraint on the Federal Reserve System in this process of “monetizing the debt” is a moral one, which explains why participants in the financial markets pay so much attention to the beliefs of Federal Reserve chairmen. Since World War II, precisely this kind of government financing has caused the unprecedented increase in the general price level, which deserves to be called the “Great Inflation” because nothing like it occurred in either the nineteenth century or the first half of the twentieth century in the United States.

Yet in the 1960s and thereafter, it became fashionable, especially among Keynesian economists, to blame inflation on practically everything under the sun: labor unions, Arab oil embargoes, crop failures, greedy industrialists, falling productivity in the goods sector, steady productivity in the service sector, and so on. As inflation accelerated, successive presidents made feeble gestures toward its containment. The Kennedy and Johnson administrations resorted to “jaw-boning,” or forceful “talks” with business and labor leaders, exhorting them to hold the line on wages and prices. Economists touted numerous plans to control inflation, including “wage-price guidelines,” “incomes policies,” and tax concessions for those who behaved well (tax-oriented incomes policy, or TIPS).

Such measures cannot stem inflation, because they treat the symptom and not the disease of excess money. Nevertheless, as inflation accelerated, reaching what later became an acceptable annual rate of 4.5 percent, the Nixon administration in 1971 instituted full-fledged wage and price controls and suspended gold convertibility of the dollar in international markets. Inflation continued while the Ford administration advocated the wearing of buttons inscribed with the word “WIN” (for “Whip Inflation Now”) and President Carter declared that inflation was a national malady and the

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9. Lawrence K. Roos (1986), who has sat on the Federal Open Market Committee of the Federal Reserve, points out that from the political point of view, one of the major uses of the Fed is that Congress can make it a scapegoat for high interest rates. But the Fed makes the same use of Congress. Hence, responsibility is diffused and accountability is avoided.

10. I omit from this lugubrious tale the near collapse of the savings and loan industry, a direct result of the interaction of banking laws passed during the Roosevelt administration in the 1930s and inflation-induced high nominal interest rates of the 1970s and 1980s. See Benston and Kaufman 1990.

fault of the people—a message that did not sit well with the people themselves. These gestures would have been comical had they not been so pitiful.<sup>10</sup> This tale of monetary mismanagement is doubly damning to macroeconomists, because they have understood for a long time the ruinous effects of excess money creation, yet few of them came forward to condemn these practices.<sup>11</sup>

Milton Friedman (1997) has recently pointed out that the harm done by Keynesian economics has more to do with Keynes's political ideas than his technical economic theories. The acceptance of Keynes's belief that government actually serves the public interest and that benevolent dictatorship (by the right people) is desirable has led many economists to regard themselves as part of a mandarin state when operating in the realm of economic policy, especially at the macroeconomic level. The idea that an economy can operate on its own does not please them aesthetically. To them, the free economy is too messy, out of control, even dangerous;<sup>12</sup> it must be managed and, in the Keynesian tradition, by the right people. Friedman notes that these beliefs took hold in Great Britain more than in the United States because of our less aristocratically oriented social structure. Thus we spared ourselves at least some of the more egregious social engineering suffered by the British.

Macroeconomics presents many long-run versus short-run contradictions. Even if saving tends to depress current economic activity as Keynes believed, it is clearly necessary for long-run growth. Even if income redistribution pleases the poor today, it will sadden them tomorrow because it stifles innovation. Even if generous government-mandated employment benefits please unions today, these same benefits will probably make unions unhappy tomorrow when jobs vanish as they have in Europe. Even if a short-run trade-off exists between unemployment and inflation (as those who still believe in the Phillips curve think), in the long run, the attempts to exploit this trade-off will result in no greater employment but a higher level of inflation.<sup>13</sup>

This list could be extended almost indefinitely. It makes clear that much macroeconomic policy should be viewed as we view narcotics: in light of the dangers posed by short-run "solutions," wisdom dictates taking the long view. Clearly, professional macroeconomists need to more actively remind politicians of the long run. But, as public-choice economists constantly point out, politicians almost always take the short view, regardless of economists' advice.

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11. Among those who did come forward were Milton Friedman, Karl Brunner, Allan Meltzer, F. A. Hayek, Henry Hazlitt, and Murray Rothbard. In general, the Austrian, monetarist, and public-choice schools most actively opposed inflationary finance, emphasizing its destabilizing character (both economically and politically), the extreme short-run view of bureaucrats, and the validity of the quantity theory of money, an idea one can trace as far back as Copernicus (see Rothbard 1995, 165).

12. For a fine discussion of how the core of modern liberalism has degenerated into questions of aesthetics, see Bartley 1995.

13. For a fascinating discussion of the politics behind the Samuelson-Solow transformation of the Phillips curve into something not believed by A. W. H. Phillips or J. M. Keynes, see Leeson 1997. In brief, the idea of a trade-off between inflation and unemployment was viewed as helpful to J. F. Kennedy's presidential election effort.

## Does Macroeconomics Predict Well?

Macroeconomics is one of the fields of economics brought to the fore in the twentieth century; econometrics—the application of statistical methods to economics—is another. Econometricians initially concentrated on microeconomic studies such as the estimation of demand and cost curves, but econometrics (especially time-series analysis) is now a staple of macroeconomics. In the past few decades, however, economists have exhibited a growing disenchantment with the idea that econometrics, suitably refined, can serve as the bedrock of useful economic research.

In the 1960s, when millions of dollars were spent on projects such as the Brookings model, most economists exuberantly anticipated the fruitful application of econometrics to macroeconomics.<sup>14</sup> Courses in statistics and quantitative methods came to dominate the graduate curriculum at the expense of “softer” fields such as the history of economic thought and economic history, much to the detriment of the broad education needed by economists. More recently, however, after thousands of empirical studies and much sophisticated refinement of econometrics, the fruits of the statistical analysis of macroeconomic activity appear meager. Disillusionment has manifested itself in the most prestigious economics journals, in the form of papers bearing such uncongenial titles as “Let’s Take the Con Out of Econometrics” (Leamer 1983). Prominent mainstream economist Lawrence Summers (1991) has pointed out that economists now distrust empirical studies, accepting “natural experiments” more readily than parametric estimates.

The forecasting failures of macroeconomic models have been appreciated for a long time. For example, three decades ago Rendigs Fels and C. Elton Hinshaw (1968) showed through an analysis of Federal Reserve minutes that the Fed generally could recognize business cycle turning points only *after* they had occurred. As far as I know, this situation has not changed. Nor do other government agencies seem to do any better; some, such as the politicized Council of Economic Advisors, generally do much worse.

Of course, the use of aggregates gives rise to some of the forecasting failures of macroeconomic models, but another difficulty is that econometrics needs a stable historical environment in order to employ historical data to make inferences about the future. Econometricians call this the problem of a “stable structure.” Unfortunately, the structure of an economy may change so rapidly that statistical modeling using historical data loses touch with reality. Again, Mises (1963) makes a strong statement:

In the field of praxeology and economics no sense can be given to the notion of measurement. In the hypothetical state of rigid conditions there are

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14. Yet the Brookings model went out with a whimper, not a bang, when it was declared “an internally incompatible model since definition of variables, data and identities were either inconsistent or incomplete” (see Duesenberry, Fromm, Klein, and Kuh 1969, n. 1).



no changes to be measured. In the actual world of change there are no fixed points, dimensions or relations which could serve as a standard. (222)

Statisticians might take comfort in the identification of Mises' "rigid conditions" with "cross-section analysis"—the comparison of variables at a fixed moment in time. However, although few statisticians would subscribe to Mises' extreme pessimism, they would agree that statistical comparisons are very difficult even in these conditions, especially if, as is often the case, the comparisons are international. And when time is introduced, the complications become nearly insurmountable in most practical situations, for when we attempt a comparison of some aggregate during a span of time, we must assume (1) that some stable econometric structure exists to ground the comparison (as in the case of the cross-section) *and* (2) that the measurable aggregates (whose internal components can now change through time) do not mask the microeconomic behavior causing those very changes.

A related problem with econometric models, now known as the Lucas critique,<sup>15</sup> concerns the lack of autonomy of these models because of the interrelationship of expectations and outcomes. For the sake of argument, suppose that a set of structural equations accurately describes the behavior of an economy and that an econometrician wishes to use the equations to simulate, say, the effect of an income-tax cut. Such a simulation could produce erroneous results because the structure of the economy with the tax cut might differ from the structure when the model was estimated. Some early econometricians, such as Trygve Haavelmo, recognized this problem, but others gave it less credence. Ragnar Frish, for example, argued that the economy had a "super-structure" that remained constant even as other relationships changed. Frish defined these kinds of invariant relationships as having a high degree of "autonomy," arguing that an early macroeconomic model estimated by Jan Tinbergen had failed to capture these relationships, the only ones that correspond to economic theory.<sup>16</sup> Frish offers the following example:

[T]he demand function for a consumers [*sic*] commodity as depending on price and income and perhaps on some secondary variables will, if the coefficients can be determined with any degree of accuracy, come fairly near to being an autonomous relation. It will not be much changed by monetary policy, in the organization of production, etc. (Morgan 1990, 126)

The question of the autonomy of an economic relationship to be estimated by statistical methods arises in the current argument over the proper way to estimate the effects of a tax change on the economy. Anyone who listens to "talk radio" knows that

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15. This critique is generally cited as one of the "new classical" criticisms of Keynesian economics. For a discussion of it, see the entry "Lucas Critique," by Peter Matthews, in Cate 1997, 384.

16. See Morgan 1990, 125 ff. Criticisms by Friedman and Haavelmo are also detailed in this source.

this question involves what is currently called “static versus dynamic modeling,” a debate in which critics fault the use of models based merely on history, as opposed to models that attempt to take into account how the historical structure might change because of the tax change.

Many econometricians believe that such problems can be handled, at least in principle, by adopting ever more general and complete models. But practical work in econometrics clearly does not indicate that more general models (in the sense of more equations or more complex structures) produce superior forecasting results. Indeed, extrapolation by the use of simple (“naive”) techniques often gives results demonstrably superior to those of complicated econometric models in a number of practical situations (Brodie and de Kluyver 1987). Alas, much research indicates that simple autoregressive-moving-average models, which usually simply ride trends and say next to nothing about turning points, forecast at least as well as expensive econometric models that need “tweaking” by their creators to have much forecasting accuracy.

All econometric models must contain “exogenous” variables to drive them (Bolch 1976). No model can achieve completeness unless it performs the impossible feat of transforming itself from a map of reality into reality itself. At a bare minimum, the model cannot contemplate the mind of the model builder. That contemplation must be left to the Deity. Therefore, the problem is not really one of small *versus* large models; rather, it involves the deeper question of whether any mathematically specified model of an economy can ever be free, structurally, of the influence of the behavior of unexplained variables that affect the structure of the economy in unspecified and surprising ways. Contrary to Frish’s belief, an economy may have no autonomous core. Hence, the model builder may be doomed to fail in creating practical models that outperform enlightened common sense.

So for those who believe, as does Milton Friedman (1953), that the proof of an economic model lies in its forecasting ability, the forecasting record of macroeconomic models affords little solace. Apart from the criticisms just discussed, to fit curves to the aggregate economy, one needs a supporting structure of *a priori* beliefs, which only macroeconomic theory can (but does not) provide. Statistical inference certainly cannot provide these beliefs. Inspecting the term *ad hoc* in *The Cambridge Dictionary of Philosophy* (Audi 1997), one finds the depressing (to econometricians) instruction “See Curve-Fitting Problem.”

## Macroeconomic Policy

Economics professors usually teach undergraduates that macroeconomic policy has two dimensions—fiscal policy and monetary policy. Ostensibly, fiscal policy deals with the taxing and spending decisions of a benevolent government for the good of the people. In conjunction with monetary policy, it is supposed to stabilize the business cycle for the good of all.

Consider first whether the business cycle *should* be stabilized—granting, for the sake of argument, that doing so is possible. Keynesians believe that business fluctuations should be eliminated and that government alone (assuming, of course, that the right people are in charge) can eliminate them.<sup>17</sup> But Joseph Schumpeter, a celebrated theorist of business cycles, regarded them as a necessary feature of economic growth. Dennis Robertson, who collaborated with Keynes, held a similar view. Friedman has argued for decades that government attempts to stabilize the business cycle could well exacerbate it. And Robert Lucas now irritates macroeconomists by asking whether the costs of an uncontrolled business cycle are large enough to offset the great costs of attempted government control. Still, the perfectionist Keynesian vision remains so taken for granted that in the vast majority of undergraduate macroeconomics courses, government control of the business cycle is treated as both proper and efficacious.

Now consider whether the business cycle *has* been stabilized. Do economic fluctuations differ in amplitude or duration from those, say, prior to the Great Depression? The research of Christina D. Romer (1986) casts doubt on the general belief that the U.S. economy is more stable now (in terms of either production or employment) than it was prior to the 1930s.<sup>18</sup> Considering the enormous effort expended on stabilization policy, the inability of researchers to give a strong positive answer to the stability question serves as yet another indicator of the paucity of progress in macroeconomics.

A consensus may develop against the use of fiscal policy. K. F. Wallis (1989, 57) notes that since the 1970s, professional economists have become increasingly frustrated with both demand management and macroeconomic forecasting. This point is seconded in a recent book by M. Deane and R. Pringle (1994, 113), who date the general loss of faith in demand management to the oil-price shock of 1973 and the poor performance of economies that tried to spend their way out, relative to those that allowed markets to adjust to the new conditions on their own.

We are left with monetary policy. Yet, as I have pointed out, monetary policy is clearly an instrument that should be restrained by long-run thinking. Macroeconomists must now guard against the propensity to attempt to use monetary policy in new and “creative” ways to “solve” short-run problems. Martin Eichenbaum (1997) remarks: “Over the long run, all that monetary policy can do is provide a stable environment within which agents can make decisions” (237). But monetary policy is not neutral over the short run, and the political winds that push central banks to monetize government debt are difficult to lean against.

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17. This perfectionist notion and its attendant hubris have led to a complete politicization of the business cycle, creating the rather absurd view, apparently widely held by the electorate, that the president bears direct responsibility for the short-term behavior of the economy.

18. For a somewhat contrary view, see Diebold and Rudebusch 1992.

## A Return to Classical Economics?

James Buchanan (1989, 4) has written that the classical economists paid little attention to making detailed economic predictions, seeking instead to develop a framework for discussing alternative economic institutions. Like the Keynesians, the classical economists approved of removing elements of uncertainty from the economy, but they espoused changing institutional arrangements rather than taking direct policy action on aggregates.

For those who appreciate the classical heritage, it was refreshing that at the same American Economic Association convention that spawned the question about a believable core of macroeconomics, S. T. Easton and Michael A. Walker (1997) presented a paper on the connection between economic freedom and economic growth. They concluded that variables measuring economic freedom have as much importance for explaining economic growth as the more standard aggregate variables, such as physical investment and education.

It would take me far afield to review the exciting new areas of research opened up in recent years as economists have struggled to define and measure economic and political freedom, and to assess its impact.<sup>19</sup> Clearly, this reframing of the discussion of long-run economic growth and development in terms of institutional arrangements will help return macroeconomics to its classical roots. In consequence, macroeconomics will become much more believable.

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<sup>19</sup> See, for example, Borner, Brunetti, and Weder 1995; Gwartney, Lawson, and Block 1995; Johnson and Sheehy 1996; Lal and Myint 1996; Powelson 1994; Putnam 1993; Scully 1992; and Walker 1988.

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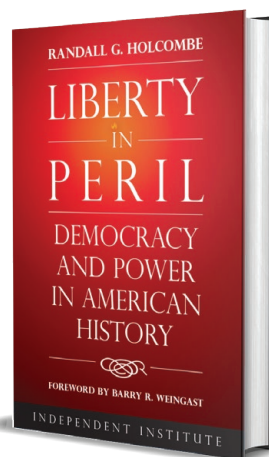
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