

# theirview

## An economics to fit the facts?

**Economists must rely more on a nuanced understanding of human behaviour while rendering policy advice**

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is a civil servant. These are his personal views.

The discipline of economics is by consensus one of the major casualties of the recent global financial crisis. Fiscal multipliers and monetary policy have not performed as modelled, the much-programmed financial markets have not worked rationally, near term economic forecasts based on the International Monetary Fund (IMF)'s intimidating dynamic stochastic general equilibrium (DSGE) simulations have repeatedly failed, and there continues to be great confusion even over something as basic as measuring growth potential. Barry Eichengreen recently pointed to some drawbacks in the economics discipline currently practised ([mintne.us/IIFA7Ms](http://mintne.us/IIFA7Ms)). However, his empiricist pursuit of the holy grail of the perfect model through a new "evidence based economics" that will fit all the facts is likely to meet the same fate as all those that preceded it, such as the IMF's new "MAPMOD" that embeds the financial sector in the tried and failed DSGE model. Historians have been there and moved on. It is time that the younger discipline of economics did likewise.

Latter-day economists, it seems, have still to reconcile themselves to the humbling fact that their discipline is a social and not a natural science; that their subject matter consists of human behaviour for which there can never be any natural laws beyond some universal foibles, such as greed, jealousy, selfishness, thrift, pride, prejudice, etc. personified in the classics of literature. These classics remain evergreen because people have related to them across space and time as they distil the essence of what it is to be human. That is why we can relate more to Thucydides' *History of the Peloponnesian War*, which ascribed human actions to such foibles, than to Herodotus' more famous *History*, which ascribed it to divine intervention. This is why we still relate to Micawber's advice to

David Copperfield in the Charles Dickens classic: "Annual income twenty pounds, annual expenditure nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery." This iron law of the consequences of leverage can scarcely be bettered. But it is too general a tool for model building. Not all humans are profligate. This is why all model building and universal laws relating to the human condition have floundered, most famously those devised by Karl Marx. It could plausibly be argued that while individual behaviour can vary because of personality differences, macroeconomics is about aggregate behaviour that is more predictable and therefore programmable. To take an example from physics, while particle behaviour at the sub-atomic level is unpredictable, in the aggregate the physical world functions according to natural, immutable laws. Might not the same apply to human behaviour? Is human behaviour in the aggregate rational and profit maximizing as Adam Smith assumed, or subject to some subconscious, almost Freudian urges as recently underscored by behavioural economists such as Richard Thaler and Cass Sunstein?

There are, unfortunately, critical behavioural differences in response to similar circumstances across both space and time at the aggregate level. An increase in income can induce people in one part of the world to save more (think Angela Merkel's Swabian housewife), others to spend more (think the stereotypical credit card-happy American housewife). Likewise, Asian societies behave like ants and save more than Latin American societies that behave more like grasshoppers. The response in the same place may be quite different in different periods, such as in pre-capitalist peasant societies that valued leisure more and cut back on production in response to higher prices.



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Even to this day the French and Italians value leisure more than Americans and this is reflected in their economic behaviour. The same people behave quite differently in an economic boom and in a recession. Think "Ricardian equivalence," "Minsky moment" and Keynes's "animal spirits." Data-dependent relationships, and even broader generalizations, derived from a specific time or place may not hold elsewhere or at other times. To get around this problem, historians turned to the narrative as an analytical tool, because describing the way things happened turned out to be not very different from explaining why they happened. We need to recognize that similar facts need not result in similar outcomes across space and time.

In these circumstances, is it surprising that IMF's models do not yield accurate forecasts of growth even in the next quarter, except in times of exceptional macroeconomic stability where future trends are a replica of past trends? In financial markets, where sophisticated model-building drives investment, interconnectedness and the critical role that

confidence plays can on their own gut any model, and they repeatedly have. The relationships between variables based on past data used to generate coefficients may not work going forward because there may not be any causal relationship between correlated data, and the correlation itself may not hold going forward. Models based on data derived from one area may not work in other areas.

The bottom line is that models and algorithms are useful, indeed desirable to avoid human error, where outcomes are dependent on physical and natural laws, such as flying aircraft or driving cars. The problem arises when algorithms are pushed to apply to areas such as economics and finance, where outcomes are contingent on human behaviour. Economists consequently need to rely less on complex universally applicable models and incorporate a more nuanced understanding of human behaviour as they go about reinventing their discipline and rendering policy advice.

Comments are welcome at [theirview@livemint.com](mailto:theirview@livemint.com)

# otherviews



## Subplots cloud Greek drama

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Successful television series engage viewers by studding a long-running storyline with discrete subplots that usually are resolved in an individual episode. These shows often falter when the underlying plotline gets lost in the subplots.

Until now, the Greek drama has met the criteria for a successful show: The theme was the country's commendable quest to stay in the euro zone. This narrative spoke to Western Europe's regional integration project, which has played a central role in transforming a conflict-torn region into an admirable oasis of peaceful coexistence and cooperation. And it acts, both in reality and in perception, as a counter to multiple external threats to Western democratic values.

The main protagonists of this central storyline are the tireless political leaders who, time and again, have managed to overcome distractions and successfully meet last-minute deadlines. They unite, usually at the 11th hour and, despite recurrent disappointments and unmet promises, skilfully manage to win over

their sceptical and sometimes restive constituents, including easily rattled financial markets.

But this powerful and, until quite recently, predictable formula is running into serious trouble. Specifically, it is threatened by five subplots that may be about to hijack the main storyline:

1. By the end of last week, critical working relationships had devolved into fierce public acrimony, fuelling increasingly stinging partisan rhetoric. Having entered the week urging the country's creditors to be "realistic," Greek Prime Minister Alexis Tsipras informed parliament on Friday that the proposals he had been presented by creditors were "absurd." Further, he suggested that the offer his European partners had made in writing departed significantly from what they had earlier indicated to him orally.

2. Seeking to strengthen its own negotiating stance, Greece decided Thursday to postpone a €300 million payment to the International Monetary Fund (IMF), one of the world's very few "preferred

creditors." In the process, Greece defiantly signalled its willingness to remain a fully cooperative working member of the international community was in doubt, along with its financial capacity.

3. These Greek provocations led the usually polite European Union president, Jean-Claude Juncker, to deliver a rather blunt warning to Tsipras over the weekend. "Friendship, in order to maintain it, has to observe some minimal rules," Juncker said Sunday. This reaction is notable because the EU president has gone to enormous lengths to maintain a working relationship between Greece and its more demanding creditors.

4. The Greek gambit was particular embarrassing for the IMF, which had confidently stated that the country would make its scheduled payment.

5. Witnessing this dysfunction, ordinary Greek citizens scrambled to do more to protect their dwindling savings. Partial indicators point to continued withdrawal of bank deposits, capital flight and a growing consensus that capital

controls will soon be required.

These five subplots could divert the main storyline away from the struggle to reconcile differing views of what Greece needs to do to remain in the euro zone, including the right mix between budgetary austerity, structural reforms, debt relief and emergency cash.

Facing an intensifying trust deficit and worsening coordination failures, the leading actors—the region's political leaders—increasingly risk being relegated to secondary roles. Meanwhile, the ensemble in this drama—citizens subjected to a protracted and suffocating economic and financial crisis—is increasingly taking on more of the decision-making role on the ground. The more this occurs, the greater the probability that a new and very different storyline will impose itself—one that focuses on the uncoordinated, disorderly and uncontrolled exit of Greece. **BLOOMBERG**

Edited excerpts. Comments are welcome at [otherviews@livemint.com](mailto:otherviews@livemint.com)