SMITH VERSUS KEYNES: ECONOMICS AND POLITICAL ECONOMY IN THE POST-CRISIS ERA

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INTRODUCTION

Alongside politicians, bankers, and CEOs, few groups have received as much opprobrium for the 2008 financial crisis as economists. "Economists are the forgotten guilty men" was the phrase employed in February 2009 by Anatole Kaletsky, editor-at-large for the London *Times*, when explaining why "a bank with just $1 billion of capital [would] borrow an extra $99 billion and then buy $100 billion of speculative investments."[1] Self-indulgence and imprudence had a part, but so too, Kaletsky asserted, did those economists who insisted that their models "proved" that occurrences such as Long Term Capital Management's demise in 1998 or Lehman Brothers's collapse almost exactly ten years later were mathematically likely to happen only once every billion years.[2] Kaletsky's wider claim was that mainstream economics had been so discredited by the financial crisis that economics itself required an "intellectual revolution" or risked being reduced to a somewhat suspect sub-branch of mathematical modeling and statistical analysis.

Kaletsky has not been alone in making such arguments. Economic historian Harold James made a similar point, albeit more temperately:

> [A]n overwhelming majority of modern economists were misled by treating short-term trends as if they were permanent phenomena that could be used to derive reliable behavioral correlations and extrapolations. There were some exceptions . . . but such analysts were dismissed as alarmist or

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1. Anatole Kaletsky, Op-Ed., *Economists are the forgotten guilty men*, TIMES (London), Feb. 5, 2009, at 28.

2. *Id.*

> eccentric, not only by the commercially driven economists who worked for financial institutions as de facto salesmen, but also by the overwhelming majority of academic economists, who were also subject to commercial pressures in the forms of peer evaluation and patterns of career development. These economists instilled a false complacency in politicians and other policymakers.[3]

In March 2009, Willem Butler, a former external member of the Bank of England's Monetary Policy Committee, likewise referred to "[t]he unfortunate uselessness of most 'state of the art' academic monetary economics."[4] Though unwilling to demand either a complete paradigm change or a defenestration of the economics profession, the *Economist* suggested that the financial meltdown raised profound questions of coherence about two specific fields of economics: financial economics and macroeconomics. "Few financial economists," it suggested, "thought much about illiquidity or counterparty risk, for instance, because their standard models ignore it." Likewise, "[m]acroeconomists also had a blind spot: their standard models assumed that capital markets work perfectly."[5]

These claims evoked a strong riposte from the Nobel Prize economist Robert Lucas in defense of the Efficient Market Hypothesis (EMH), the claim that the price of a financial asset reflects all relevant, generally available information. "One thing," Lucas wrote, "we are not going to have, now or ever, is a set of models that forecasts sudden falls in the value of financial assets, like the declines that followed the failure of Lehman Brothers in September [2008]."[6] Since the late Paul Samuelson published his proof for one version of the EMH in 1965 and Eugene Fama detailed the theory and evidence for three forms of the EMH in 1970,[7] the EMH had been subject to consistent criticism. But none of these critiques, Lucas maintained, had proved its falsity. Other economists, however, argued that the

3. HAROLD JAMES, THE CREATION AND DESTRUCTION OF VALUE: THE GLOBALIZATION CYCLE 6 (2009).

4. Maverecon, http://blogs.ft.com/maverecon/2009/03/the-unfortunate-uselessness-of-most-state-of-the-art-academic-monetary-economics/ (Mar. 3, 2009, 13:37 GMT).

5. *What went wrong with economics*, ECONOMIST, July 18, 2009, at 11.

6. Robert Lucas, *In defence of the dismal science*, ECONOMIST, Aug. 6, 2009, at 67.

7. *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work,* 25 J. FIN. 383 (1970); Paul A. Samuelson, *Proof That Properly Anticipated Prices Fluctuate Randomly*, 6 INDUS. MGMT. REV. 41 (1965).

stock market meltdown demonstrated the EMH's inability to account for the market overpricing assets such as mortgages. On this basis, they conjectured, "the EMH, as applied to the stock market in aggregate, must be discarded or modified."[8]

While these discussions are important, much of the debate about economic theory following the 2008 crisis has focused upon the place of models in economics. Some contemporary economists seem hesitant to question the appropriateness of their heavy dependence on models and mathematical logic. This hesitance may arise because they want to avoid raising difficult questions about the very nature of postwar mainstream economic science.

Since John Maynard Keynes's time, mainstream economics has undergone a steady process of mathematization and immersion in abstraction. One need only glance through their nearest copy of the *American Economic Review* and observe the plethora of algebra that is now central to most mainstream economists' argumentation. Outside the Austrian school of economics, few economists have publicly questioned this dependence. One economist willing to do so, however, was Wilhelm Röpke (1899–1966). Röpke is well known as one of the intellectual architects of postwar West Germany's path from National Socialist economic collectivism to a market-driven economic miracle in the decade following West Germany's economic liberalization in 1948. Less attention, however, has been given to Röpke's passionate critiques of postwar developments in economics as a social science. On one level, these denunciations were driven by Röpke's belief that policies based upon Keynesian-influenced economics would gradually diminish economic and political liberty. But another source of Röpke's angst was his conviction that Keynes and, more par-

8. Posting of Andrew Smithers to Free Exchange, http://www.economist.com/blogs/freeexchange/2009/08/lucas_roundtable_the_emh_must.cfm (Aug. 11, 2009, 20:42 GMT). Certainly there is, as Nobel Prize-winning economist Myron Scholes notes, a difference between those creating the models (academic economists) and those applying these models (Wall Street financial engineers) in the marketplace. *See Efficiency and Beyond*, ECONOMIST, July 18, 2009, at 68. Many economists who support a "weak" EMH have introduced numerous qualifications based on their willingness to import insights from other disciplines to explain apparently irrational economic behavior. *See, e.g.*, Kam C. Chan et al., *International Stock Market Efficiency and Integration: A Study of Eighteen Nations*, 24 J. BUS. FIN. & ACCT. 803 (1997); Barr Rosenberg et al., *Persuasive evidence of market inefficiency*, 13 J. PORTFOLIO MGMT. 9 (1985).

ticularly, his many disciples were slowly undermining the integrity of economics as a social science. Though Röpke died over forty years ago, his analysis of trends in economic science following Keynes's *General Theory*[9] provides useful insights into some of the challenges confronting contemporary economics. It also contains some intimation of a possible direction for post-crisis economics, one closer to the vision of Adam Smith than the legacy imparted by Keynes and his successors.

I. ECONOMICS, POSITIVISM, AND SCIENTISM

Reflecting on the fortunes of economics in the 1950s, Röpke marveled at the enormously augmented scope for economic research.[10] He contrasted it with the economics profession's situation in prewar Germany as a lowly handmaiden to faculties of law.[11] Postwar economic science enjoyed a stature that had previously eluded the discipline, partly, Röpke thought, because a range of difficulties had emerged since the 1930s that caused many to turn to economics for responses.[12] But, Röpke held, these new realities were actually grounds for considerable concern about postwar changes in economics as a social science.

"The economist, too," Röpke once wrote, "has his occupational disease: restricted vision."[13] Emphasizing that he spoke from personal experience, Röpke suggested that some economists found it hard to look beyond their own discipline or concede that the economy was part of a larger order about which other sciences had things to say.[14] This provincialism was magnified by the error of "economism," the habit of viewing "everything in relation to the economy and in terms of material productivity, making material and economic interests the center of things by deducing everything from them and subordinating eve-

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9. JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY (1936).

10. This Section draws on SAMUEL GREGG, WILHELM RÖPKE'S POLITICAL ECONOMY (2010).

11. *See* Wilhelm Röpke, *The Place of Economics Among the Sciences*, *in* ON FREEDOM AND FREE ENTERPRISE: ESSAYS IN HONOR OF LUDWIG VON MISES 111, 112 (Mary Sennholz ed., George D. Hunckle trans., 1956).

12. *See id.* at 114.

13. Wilhelm Röpke, *The Economic Necessity of Freedom*, 3 MODERN AGE 227, 234 (1959).

14. *Id.*

rything to them as mere means to an end."[15] Economic research, Röpke insisted, would not be productive if economists largely ignored the complexity of the world in which economic choices and policies operate.[16] Economism invariably led economists into the trap of what Röpke called "social rationalism," the tendency to regard market mechanisms as value-neutral methods applicable to any economic or social order. One example was the attempt of socialist economists such as Oskar Lange to reconcile the price mechanism with collectivist economies. How, Röpke asked, could a mechanism that assumes human freedom operate in societies premised on the radical subordination of liberty?[17]

It followed, according to Röpke, that economists should seek to avoid segmenting economic inquiry from the complex character of human nature. Though attentive to utility, Röpke rejected the neoclassical premise of humans as rational utility maximizers: "The ordinary man is not such a *homo œconomicus* . . . . The motives which drive people toward economic success are as varied as the human soul itself."[18] Nor did Röpke consider it reasonable to premise economic theory on an understanding of humans as selfless creatures.[19] Instead, Röpke invoked a rather Smithian understanding of human beings to explain his fondness for market economies over the alternatives:

> There is a deep moral reason for the fact that an economy of free enterprise brings about social health and a plenitude of goods, while a socialist economy ends in social disorder and poverty. The "liberal" economic system delivers to useful ends the extraordinary force inherent in individual self-assertion, whereas the socialist economy suppresses this force and wears itself out in the struggle against it. Is the system unethical that permits the individual to strive to advance himself and his neighbor through his own productive achievement? Is the ethical system the one that is organized to suppress this striving? . . . It makes virtue appear irrational and places an extravagant demand upon human nature when men in serving virtue in a collectivist economy must act against their own

15. WILHELM RÖPKE, THE SOCIAL CRISIS OF OUR TIME 53 (Peter S. Jacobsohn trans., Transaction Publishers 1992) (1942).

16. Röpke, *supra* note 13.

17. *See* WILHELM RÖPKE, A HUMANE ECONOMY: THE SOCIAL FRAMEWORK OF THE FREE MARKET 93–94 (Elizabeth Henderson trans., ISI Books 3d ed. 1998) (1960).

18. *Id.* at 121.

19. *See* Röpke, *supra* note 13, at 233–34.

> proper interests in ways that, as even the simplest of them can see, do nothing to increase the total wealth.[20]

Röpke was also impatient with economic theories that diminished the study of individual human choice and action to relative insignificance.[21] This diminishment, Röpke maintained, was the product of scientism's effect upon economics. He defined "scientism" as the tendency to "understand by science [what] is merely fundamentally the narrow territory of the 'positivist' and 'exact' natural sciences and their technical application."[22] Scientism embodied the notion that there were no limits to the cognitive capacities of positivist methodology and technical analysis. It was usually associated with "an optimistic belief in progress by means of a mechanical leadership of society."[23] The result was "the scientific elimination of the Human element in political and economic practice."[24]

Röpke also treated scientism as destructive of humanity's centuries-old striving towards a unity of knowledge, epitomized by the medieval and early-modern scholastic tradition. Though he agreed that "the endless multitude of possible problems"[25] necessitated specialized intellectual inquiry in both the humanities and sciences, both social and natural, Röpke underlined "the utter futility of a science which progressively heaps up matter, which is always measuring, analyzing, and documenting but which continually gets further and further away from a synthesis."[26] It created people

> whose head[s] . . . [are] filled exclusively with "useful" knowledge and who cannot grasp that abstract natural science and physics possess quite a different educational value from the moral sciences . . . that the science of mathematics is an admirable, nay an indispensible training for the intellect but that when it has done its work it can be put aside.[27]

20. *Id.* at 233.
21. *See* Wilhelm Röpke, *Selbstbesinnung der Wissenschaft*, 10 NEUE SCHWEIZER RUNDSCHAU 4 (1942).
22. WILHELM RÖPKE, CIVITAS HUMANA: A HUMANE ORDER OF SOCIETY 61 (Cyril S. Fox trans., 1948).
23. *Id.* at 69.
24. *Id.* at 63.
25. *Id.* at 75.
26. *Id.* at 70.
27. *Id.* at 66.

Scientism "implies simultaneously disdain for synthesis. It means ever more specialization, the breeding of a learned type."[28] Among economists, scientism had helped to facilitate "the disinclination of so many economists to make contact with sociology, ethics or politics."[29] This isolation of economists from the rest of the academy added up to a cult "of endless documentation, of Empiricism and Historicism, of the quantitatively measurable, of research *more geometrico* to the detriment of the humane sciences (the moral sciences), and their orientation towards the natural sciences as the one ideal to be pursued in everything."[30]

Much of Röpke's appraisal of scientism's impact upon economics parallels and draws upon another twentieth-century advocate of free markets, Friedrich von Hayek.[31] In Hayek's view, scientism undermined economics insofar as it encouraged the illegitimate importation of the techniques of the natural sciences into a social science.[32] Röpke also shared Hayek's concern that scientism in economics encouraged collectivist economic thinking. The post-Enlightenment "faith in the mission of rationalism for the reconstruction of society, faith in the task of 'organiser scientifiquement l'humanité,'"[33] had simply misled some to believe economic life could simply be reorganized along more "rational" lines than market economies.

II. ECONOMISTE-PHILOSOPHES OR ECONOMETRICIANS?

The influence of positivism and scientism on economics marked, according to Röpke, a departure from the understanding of economics Adam Smith articulated. In Röpke's view, Smith was "a representative of the humanist spirit of the eighteenth century," whose *Wealth of Nations*[34] formed part of a larger intended work on "the cultural history of mankind" in which "economics was viewed as an organic part of the larger

28. *Id.* at 68.
29. *Id.* at 79.
30. *Id.* at 68.
31. *See, e.g., id.* at 59 n.12.
32. *See* F.A. HAYEK, THE COUNTER-REVOLUTION OF SCIENCE: STUDIES ON THE ABUSE OF REASON (1952).
33. RÖPKE, *supra* note 22, at 64.
34. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776).

whole of the intellectual, moral, and historical life of society."[35] As the author of *The Theory of Moral Sentiments*,[36] Smith understood that his *Wealth of Nations* did not and could not encapsulate human life in its entirety.[37] Röpke asserted that Smith viewed social and economic life as the product of an invisible hand and "a living order with an immanent logic of its own which the human mind could comprehend and even destroy but could not duplicate."[38]

By way of contrast, Röpke viewed John Maynard Keynes as Smith's antithesis. Keynes was "a representative of the geometric spirit of the 20th century" and "an exponent of positivistic scientism," for whom "economics was part of a mathematical-mechanical universe."[39] When combined with the modern proclivity for statistics, this outlook actually limited economists' ability to comprehend economic phenomena.[40] Thus, although Röpke treated Smith as a promising start, he considered Keynes to embody a rationalistic deterioration in modern economics' explanatory power.[41] Although Röpke did not regard all Keynesian concepts as mistaken, he did view "Keynesianism" as a defective way of economic thinking. Röpke consigned more blame to Keynes's followers,[42] but he maintained that Keynes's approach to economics had created an "old economics" and a "new economics" in which the reason of one was the nonsense of the other.[43]

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35. WILHELM RÖPKE, ECONOMICS OF THE FREE SOCIETY 224 (Patrick M. Boarman trans., Henry Regnery 1963) (1937).

36. ADAM SMITH, THE THEORY OF MORAL SENTIMENTS (1759).

37. *See* RÖPKE, *supra* note 17, at 92.

38. RÖPKE, *supra* note 35, at 224.

39. *Id.*

40. Wilhelm Röpke, *Die entscheidenden Probleme des weltwirtschaftlichen Verfalls*, 74 ZEITSCHRIFT FÜR SCHWEIZERISCHE STATISTIK UND VOLKSWIRTSCHAFT 493, 493–506 (1938).

41. RÖPKE, *supra* note 35, at 224.

42. *Id.* at 225. In his analysis of Keynes's thought, Gilles Dostaler presents a strong case that Keynes was not the only inspiration behind the revolution that bears his name. GILLES DOSTALER, KEYNES AND HIS BATTLES 255 (Niall B. Mann trans., 2007). Other economists, such as those of the Stockholm school, were proposing Keynesian-like arguments about effective demand as early as the 1920s. *Id.* at 256. Furthermore, the mathematization of "Keynesianism" was largely pioneered by Sir John Hicks in 1937. *See* J.R. Hicks, *Mr. Keynes and the "Classics"; A Suggested Interpretation*, 5 ECONOMETRICA 147 (1937).

43. WILHELM RÖPKE, *Keynes and the Revolution in Economics: Economics Old, New, and True*, *in* AGAINST THE TIDE 167, 170 (Elizabeth Henderson trans., 1969).

Here Röpke was not referring to the difference between relatively free market and relatively interventionist economic policies. His concern was with what people thought constituted the essence of economics as a social science and the methods it employed. According to Röpke, most economists working in the post-Keynes era were inclined to reduce economics to mathematical and statistical analysis or macroeconomics. Economics consequently became a quantitative enterprise that "teems with equations in ever-increasing profusion" and that focused on the development of patterns of aggregate behavior by entire societies that bore little resemblance to reality.[44] Opening a post-Keynes economics textbook, Röpke claimed, made readers wonder whether they had purchased a chemistry curriculum.[45]

Röpke's concerns about the post-Keynes macroeconomic focus of economics did not mean that he somehow "opposed" macroeconomics. Even non-Keynesians employed terms like "a country is living beyond its means" as a way of describing how the aggregate expenditure for investment and consumption in a given area created more purchasing power than could be provided at present prices for the economy's output in that area.[46] Röpke's complaint was that Keynes had essentially "declared the method of thinking in aggregates to be the only valid one, now and in the long run."[47] This development was undermining the doctrine of the movement of individual prices, the great achievement of 150 years of economics,[48] and, thus, the real content of economics. With the appearance of a generation of economists exclusively trained to work with economic aggregates, Röpke maintained that the economist's skills were increasingly diminished to the capacity to articulate "hypothetical statements about functional relationships in mathematical formulas or curves."[49]

Here Röpke may have been thinking of Paul Samuelson's attempt to rearticulate economics in mathematical terms.[50] For Röpke, such endeavors confused the object of economics with a

44. Röpke, *supra* note 11, at 121.
45. *Id.*
46. *See* RÖPKE, *supra* note 17, at 177.
47. RÖPKE, *supra* note 43, at 172.
48. *See id.* at 171.
49. RÖPKE, *supra* note 17, at 193.
50. *See* PAUL ANTHONY SAMUELSON, FOUNDATIONS OF ECONOMIC ANALYSIS (1947).

medium of economic analysis. As Jesús Huerta de Soto noted, mathematics is a form of language based upon symbols that partly emerged as a way of facilitating the study of the natural sciences. But the functional relationships that mathematics attempts to capture in the economic world are constantly undermined by factors such as entrepreneurship, which distorts the constancy of information that mathematics demands.[51] In Röpke's view, mathematics and empirical methods were also less adequate when it came to studying the economic effects and implications of things such as traditions, institutions, and values. Mathematical formalism, Röpke argued, chose to address these realities by generally ignoring them. It thus lost sight of economics' essence, which is not macro-aggregates but the choices of individuals and institutions. On this basis, Röpke suggested that the "new economics" was destroying economics as "a 'moral science' in the sense that it deals with man as an intellectual and moral being."[52] Instead, in the new economics, the economist became a type of bureaucratic technocrat charged with preempting economic problems through the use of sophisticated mathematical quantitative methods. Consequently, the post-Keynes economist was invariably

> obsessed by one thing, i.e., "effective demand," which he thinks must be kept up at whatever cost, while he forgets the working of the mechanism of prices, wages, interest and exchange rates. Whereas formerly a good economist was a man who knew how to assess the relation of the actual economic forces and whereas formerly judgment, experience, and a sense of proportion were rated higher than the formal skill in handling certain research techniques introduced illegitimately from the natural sciences into economics—today glory goes to him who knows how to express more or less hypothetical statements in mathematical symbols and curves.[53]

Concerns about these changes, Röpke noted, were not limited to non-Keynesians. He cited one of Keynes's disciples (and first biographer), Roy Harrod, saying that substituting a fascination

51. *See* JESÚS HUERTA DE SOTO, THE AUSTRIAN SCHOOL: MARKET ORDER AND ENTREPRENEURIAL CREATIVITY 14 (2008).

52. Röpke, *supra* note 11, at 122.

53. WILHELM RÖPKE, *The Problem of Economic Order, in* 2 ESSAYS BY WILHELM RÖPKE: THE PROBLEM OF ECONOMIC ORDER; WELFARE FREEDOM AND INFLATION 1, 3–4 (Johannes Overbeek ed., 1987).

with mathematical aggregates for attention to basic economic principles had led him to conclude that "we should be better off with the old Political Economy."[54]

Drawing upon the Austrian economist Ludwig von Mises, Röpke maintained that sound economics allows mathematics to explicate certain relationships that have quantitative characteristics. But the more economics drifted in a mathematical-statistical direction, the more it ignored that which is un-mathematical and does not always behave predictably: human beings.[55] Röpke was not persuaded that mathematics could encompass the instability and complexity of economic life. Despite the apparent information such methods could obtain, economic trends rarely seemed to conform to the new economics' forecasts. The result was not only that "with all our cleverness, we have become decidedly less wise, while knowing more and more about less and less,"[56] but also that economic science was dehumanized.[57] "Keeping economics human," Röpke held, did not necessitate completely rejecting mathematics or aggregate concepts. But he did ask economists to consider that behind factors such as supply and demand, amounts of savings, volumes of investment, rates of inflation, and levels of wages were "individual human beings with their feelings, their deliberations, their appraisals of value, their collective suggestions and decisions."[58]

Röpke's warnings against the dominance of the language of aggregates and mathematics also reflected his worry that economics would gradually become unintelligible to non-economists and of decreased usefulness to policymakers.[59] Moreover, Röpke argued that the new economics' marginalization of individual human beings reflected general social trends "toward impersonalization, toward collectivization, toward mechanization, toward dehumanization."[60] Just as modern economic science received tremendous impetus in the late-eighteenth, nineteenth, and early-twentieth centuries from the desire to understand *market* economies, Röpke maintained that

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54. *Id.* at 3 n.1.
55. Röpke, *supra* note 11, at 122.
56. RÖPKE, *supra* note 53, at 3.
57. Röpke, *supra* note 11, at 123.
58. *Id.*
59. *Id.* at 124.
60. *Id.*

mid-twentieth century economics was being influenced by the context of political and economic *collectivization* in which it was practiced.[61] The postwar "new economics" helped to support the belief that the state could "manage" the economy and therefore facilitated expectations that governments should attempt to do so. Governmental institutions committed to interventionist policies wanted macroeconomic research that added empirical credibility to such proposals. As Keynes's most important biographer, Robert Skidelsky, noted:

> The needs of Keynesian macroeconomic policy spawned vast quantities of national-income statistics which were fed into huge computer-forecasting models set up to capture the significant short-term trends of the macroeconomy. The Keynesian age was the golden age of macroeconomics: the famous economists of the time were all macroeconomists; most of them worked for or advised government at least some of the time. The study of markets and how they worked, or even failed to, was distinctly unfashionable.[62]

A form of collusion consequently developed between the postwar economic profession and states pursuing interventionist strategies. It meant, Röpke thought, that many economists had essentially compromised their integrity as scholars committed to the pursuit of truth above the temptations of expediency.

III. RELATIVIZING—NOT ABANDONING—MODELS

Röpke's diagnosis of some of the problems characterizing mainstream postwar economics is several decades old. Hence, it does not address the emergence of New Classical economics in the late 1960s, monetarism in the 1970s, the New Keynesianism of the early 1980s, or what some call the "New Neoclassical Synthesis" of New Keynesian and New Classical economics of the late 1990s. Nevertheless, Röpke's analysis plays directly into many contemporary debates about the failures, imagined or otherwise, of economics in the context of the 2008 financial crisis.

Today, as Philip Booth observes, "[t]here is a tendency in modern economics to ignore variables that do not fit neatly into econometric models. . . . [T]here may be many economic vari-

61. RÖPKE, *supra* note 35, at 227–28.
62. ROBERT SKIDELSKY, KEYNES: THE RETURN OF THE MASTER 104 (2009).

ables and processes that are not amenable to measurement or to modelling but that have important information content."[63] The presence of these variables has immediate implications for understanding complex phenomena like the role of money in creating inflation.

> It may be difficult for central banks (or financial market forecasters) to precisely model the impact of money supply on inflation as relationships have become less predictable over time. This does not mean, however, that monetary aggregates are not a very important (indeed, possibly the most important) variable in determining inflation. It simply means that to understand the processes we have to interpret the data and we may have to accept that any predictions we make are simply predictions of tendencies rather than of precise magnitudes.[64]

Consequently, not only central banks but also politicians and governments in the post-crisis era ought to tone down their rhetoric about "managing" an economy, because economic science simply does not possess the predictive abilities to validate claims to control such a complex system.

The question, however, is where do we go from here? Does a post-crisis economics involve dispensing with most of the mathematical tools and modeling that assumed such a prominent place in economic science in the wake of Keynes's *General Theory*? Are we to conclude along with Paul Krugman and others that much of the economic research of the past thirty years has been a spectacular waste of time and energy?[65]

In his famous review of Milton Friedman and Anna Schwartz's *A Monetary History of the United States*,[66] Robert Clower stated that "[i]f successful prediction were the sole criterion of the merit of a science, economics should long since

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63. Philip Booth, *Learning from the Crash, and Teaching after it*, *in* PROFIT, PRUDENCE AND VIRTUE: ESSAYS IN ETHICS, BUSINESS AND MANAGEMENT 225, 234 (Samuel Gregg & James Stoner eds., 2009) (citation omitted). Booth notes that this point was the central argument of Hayek's 1974 Nobel Prize lecture, *The Pretence of Knowledge*. *Id.* at 234 n.9.

64. *Id.* at 234.

65. *See* Paul Krugman, *How Did Economists Get It So Wrong?*, N.Y. TIMES, Sept. 6, 2009, (Magazine), at 36.

66. MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867–1960 (1963).

have ceased to exist as a serious intellectual pursuit."[67] In other words, economic science is not just concerned with making economic predictions or shaping economic policy. It is about understanding the truth about the economic dimension of human life. To this end, economists have a range of tools at their disposal, including logic, inference, historical analysis, statistics, *and* mathematics. Doubts about the predictive powers of economics should not mean that we engage in blanket disparagements of economists' use of mathematical tools. As Booth comments, "[n]eo-classical economics can be helpful for understanding particular problems. The closed form solutions to many modern finance problems, such as the pricing of derivatives, derive their method from the neo-classical way of thinking."[68] As long as there is a quantitative dimension to economics, we will need tools that allow us to compare theories about how the economy works to quantifiable data. They provide us with useful—though not all-encompassing—information about factors that economists and those they advise should be considering, ranging from matters such as the effects of interest rate increases to the growth of wealth in given societies. Though predictability in the social sciences is only imperfectly possible, the philosopher Alasdair MacIntyre correctly stated that it is often achievable thanks to our knowledge of statistical regularities, the common realization that people need to coordinate their actions, and our awareness of the causal regularities of social life and nature.[69]

A similar point applies to abstract models. Economic models are like maps. Although maps do not in themselves capture the whole truth, they do provide us with some insight into aspects of the truth. A map of London can tell us how to get from Heathrow to Westminster. It cannot, however, encapsulate London's entire reality. Similarly, economic models cannot encapsulate a holistic vision of the economy. But, depending upon the subject matter and the model's capacity to approximate aspects of reality, they can provide us with *some* information about what is happening in an economy and how to attain certain economic

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67. Robert Clower, *Monetary History and Positive Economics*, 24 J. ECON. HIST. 364, 364 (1964).

68. Booth, *supra* note 63, at 232.

69. *See* ALASDAIR MACINTYRE, AFTER VIRTUE 102–03 (1984).

objectives.[70] Some abstractness is often necessary in many social and natural sciences if we are to reach conclusions about any number of questions. As James Buchanan and Geoffrey Brennan noted, abstraction in economic science is a way "of allowing economists to impose intellectual order on the observed chaos of human interaction, without excessive distracting detail in dimensions of the analysis that are not centrally relevant."[71]

By the same token, economists should acknowledge that neoclassical economic models are only useful for certain purposes. A radically empirical, positive approach to economics is inadequate because it simply leaves out too much. A London street directory will not show us the distance between Buenos Aires and London. Nor does it tell us that we *should* travel from London to Paris. Likewise, economic models are not designed to provide us with all the information we need to resolve economic and political dilemmas. It follows that, as Buchanan and Brennan noted, even those economists who believe that applying the presumption of *homo economicus* to many problems is useful should

> recognize that *homo economicus* has its own limits as a useful abstraction. We can only load the construction with so much, and we stand in danger of having our whole "science" collapse in an absurd heap if we push beyond the useful limits. The fact that the whole set of "noneconomic" motivations are more difficult to model than the "economic" should not lead us to deny their existence.[72]

On these grounds, we may state that one useful post-crisis lesson for many economists is the need to be more cognizant of the limits of abstract modeling and wary of attempts to reduce economic concepts to mathematical formulae. Economists need to be willing, as Booth commented, to "focus on variables that are important rather than just on variables that are precisely measurable."[73] For the same reason, economists should also be willing

70. *See* SAMUEL GREGG & IAN HARPER, ETHICS AND ECONOMICS: THE DISPUTE AND THE DIALOGUE 11–13 (1999).

71. James M. Buchanan & Geoffrey Brennan, *The Normative Purpose of Economic 'Science': Rediscovery of an Eighteenth Century Method*, *in* ECONOMICS: BETWEEN PREDICTIVE SCIENCE AND MORAL PHILOSOPHY 51, 53–54 (Robert D. Tollison & Viktor J. Vanberg eds., 1987).

72. *Id.* at 55.

73. Booth, *supra* note 63, at 234.

to discourage those—including government officials, central bankers, and politicians—tempted to base entire schema ranging from particular investment strategies to government monetary policy upon one or more models, econometric or otherwise.

IV. ECONOMICS AND POLITICAL ECONOMY

If Röpke was correct in his claim that many economists' reputations in the post-Keynes era have been primarily built upon their skills as econometricians and macroeconomists, and if—as Röpke also insisted—much postwar economic science fell into the traps of positivism and scientism, then there will be considerable resistance to the suggestions above. One explanation for such resistance might be simply career preservation. Another is that a commitment (conscious or otherwise) to positivism and scientism involves an assent (again, conscious or otherwise) to a range of intellectual positions that are not so easy to discard if they have long been central to a person's habits of thinking. But if economists believe that economics is, like any other moral, social, or natural science, about the search for truth, then they have no reason to adhere to assumptions and methodologies that have, in many respects, actually limited economics' ability to wrestle with its subject matter.

One way forward might be attempting to widen the horizons of economics by seeking to engage it—especially its technical-positive dimension—in truly *synthetical* analysis. Synthesis here does not mean a version of Hegelian dialectics or the application of the *homo economicus* model to a range of problems that were traditionally outside the realm of economics. As the Austrian-school economist Murray Rothbard wrote in 1989:

> In recent years, economists have invaded other intellectual disciplines and, in the dubious name of "science," have employed staggeringly oversimplified assumptions in order to make sweeping and provocative conclusions about fields they know little about. This is a modern form of "economic imperialism" in the realm of the intellect. Almost always, the bias of this economic imperialism has been quantitative and implicitly Benthamite, in which poetry and pushpin are reduced to a single-level, and which amply justifies the gibe of Oscar Wilde about cynics, that they [economists] know the price of everything and the value of nothing. The results of

> this economic imperialism have been particularly ludicrous in the fields of sex, the family, and education.[74]

Doubtless many economists would claim that Rothbard oversimplified the character of their endeavor insofar as their application of economic research methods to such questions is not concerned with reducing everything to an economic explanation, but rather with providing new insights that might otherwise remain dormant. The broader point, however, is that such endeavors are not in themselves synthetic. A more promising path for synthesis may lie in re-grounding economics' positive-technical dimension upon a renewed Smithian understanding of political economy.

Since Antoyne de Montchrétien first coined the term in 1615 to describe how monarchs could manage their kingdoms,[75] *œconomie politique* has been defined in many ways. It was Adam Smith, however, who gave political economy its commonly accepted *positive* meaning by defining "what is properly called Political Oeconomy" as the scientific study of "the nature and causes of the wealth of nations."[76] As A.M.C. Waterman noted, Smith's political economy partly concerns the positing of scientific (in the positivist sense of the word) theories to understand economic phenomena. This scientific positing constitutes most of what is commonly understood to be economics today. In another sense, however, Waterman claimed that Smith's political economy also involves the study of the interrelationship between economic theory and the political ideas and movements of a given time.[77] Lastly, there is the sense in which Smith understood political economy in terms of what we would call economic policy, insofar as Smith treated political economy as "a branch of the science of a statesman or legislator" whose goals were first "to provide a plentiful revenue or subsistence for the people, or more properly to enable them to provide such a revenue or subsistence

74. Murray N. Rothbard, *The Hermeneutical Invasion of Philosophy and Economics*, 3 REV. AUSTRIAN ECON. 45, 45 (1989).

75. JOSEPH A. SCHUMPETER, HISTORY OF ECONOMIC ANALYSIS 167–68 (Elizabeth Boody Schumpeter ed., 1994) (1954).

76. 2 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 678–79 (R.H. Campbell & A.S. Skinner eds., Liberty Classics 1981) (1776).

77. A.M.C. Waterman, *"New Politicial Economies" Then and Now: Economic Theory and the Mutation of Political Doctrine*, *in* THE NEW POLITICAL ECONOMIES: A COLLECTION OF ESSAYS FROM AROUND THE WORLD 13, 14 (Laurence S. Moss ed., 2002).

for themselves; and second, to supply the state or commonwealth with a revenue sufficient for the publick services."[78]

On one level, Smith's *Wealth of Nations* was a work of abstract economic analysis and prescription. Smith scrutinized the prevailing mercantilist economic theories and those of the French physiocrats, presented a fresh argument about how wealth creation occurs, and then explained what might be done if society's overall material enrichment was considered desirable. But we should not forget that, as E.G. West stated, *Wealth of Nations* began not as a book on economics but as an essay in conjectural history, "the systematic study of the effects of legal, institutional and general environmental conditions upon human progress."[79] In doing so, Smith also attempted to articulate *normative* reasons for an economy based on private property, free competition, free trade, rule of law, and limited government. For Smith, the shift from mercantilist to market economies was not just a question of implementing insights from scientific economic reasoning focused on wealth creation. It was also a matter of civilizational growth. Although certain elements of commercial order disturbed Smith,[80] he also preferred market-oriented economies to previous economic arrangements on the basis not only of their greater efficiency, but also of the greater *liberty* provided by market economies to ever-widening numbers of people. Emma Rothschild reminded us that Smith saw economic liberty as something to be supported partly because of its ability to free people from many forms of subjugation.[81]

With a few exceptions, this Smithian conception of economics and political economy faded after Smith's death in 1790. Instead, economics in the Anglo-Saxon world increasingly focused upon studying the choices and actions of *homo economicus*, a being whose nature is rather different than the more sophisticated, sometimes irrational creatures in Smith's writings. By 1844, John Stuart Mill was stating:

> What is now commonly understood by the term "Political Economy" . . . . makes entire abstraction of every other hu-

78. 1 SMITH, *supra* note 76, at 428.
79. E.G. WEST, ADAM SMITH: THE MAN AND HIS WORKS 20 (1976).
80. *See* RYAN PATRICK HANLEY, ADAM SMITH AND THE CHARACTER OF VIRTUE 16–17 (2009).
81. EMMA ROTHSCHILD, ECONOMIC SENTIMENTS: ADAM SMITH, CONDORCET, AND THE ENLIGHTENMENT 27 (2001).

> man passion or motive; except those which may be regarded as perpetually antagonizing principles to the desire of wealth, namely, aversion to labour, and desire of the present enjoyment of costly indulgences. . . . Political Economy considers mankind as occupied solely in acquiring and consuming wealth; and aims at showing what is the course of action into which mankind, living in a state of society, would be impelled, if that motive, except in the degree in which it is checked by the two perpetual counter-motives above averted to, were absolute ruler of all their actions.[82]

Mill did qualify these remarks. No economist, he claimed, truly believed that this description captured humanity's essence.[83] Nevertheless, Mill did reflect a narrowing of the parameters of modern economics established by Adam Smith.

Since Mill's forays into economics, there have been many successful efforts to widen the scope of economic science, some of which have impacted mainstream economic research as well as economic policy. Examples of this impact include the Freiburg "ordo-liberal" school associated with the German economists Walter Eucken and Franz Böhm, the "new institutional economics" of Ronald Coase, Harold Demsetz, and Douglass North, as well as the "law and economics" movement promoted by figures such as Richard Posner. What distinguishes ordo-liberalism from the other schools is that the ordo-liberals were committed to integrating the "liberal" concern for liberty with the "conservative" belief in order into their economic research program and policy recommendations. In short, they treated a concern for the promotion of certain values as integral to economic inquiry and recommendations. Eucken and Böhm were especially concerned with the issue of how to preserve freedom in complex social orders based primarily upon voluntary cooperation. Like many other Germans, Eucken was worried about the accumulation of power and less convinced that the spontaneous interaction of people usually sufficed to produce a stable and flourishing social order.[84] Writing in 1933, Böhm noted that: "The experience of the last dec-

82. JOHN STUART MILL, *Of the Definition of Political Economy; and on the Method of Investigation Proper to It, in* ESSAYS ON SOME UNSETTLED QUESTIONS OF POLITICAL ECONOMY 120, 137–38 (1844).

83. *Id.* at 139.

84. *See* WALTER EUCKEN, GRUNDSÄTZE DER WIRTSCHAFTSPOLITIK (1952).

ades has shown that business associations and interest groups have mastered the art of turning every politically influential ideology to their own purpose in a most effective manner."[85] Cartels, to Böhm's mind, exemplified how private contracts, often with the support of the legal system and government, were used to shelter sections of the economy from competition. This collusion of private and public power undermined essential market mechanisms such as free prices and paved the way for extensive economic intervention and, eventually, centrally planned economies. Seeking to find ways to limit the ability of interest groups to capture state power in order to diminish free competition, Eucken and Böhm drew upon Scottish Enlightenment insights but also what might be regarded as natural law reasoning to try to establish precise parameters that recognized positive law's legitimate authority on questions of economic regulation while simultaneously limiting (often via constitutional law) that authority to very specific tasks.

This attention to values brings us face-to-face with the challenge presented by Smith's political economy to mainstream economics. It reflects the Scottish Enlightenment approach to intellectual inquiry in which there was no rigid separation of social science and moral normativity.[86] For Scottish Enlightenment figures such as Adam Ferguson, it was not simply that identifying certain normative concerns was considered central to explaining social phenomena; rather, Scottish social science sought to comprehend *and* evaluate man so that "we endeavour to understand what he ought to be."[87]

Smith's understanding of political economy certainly contained a strong positive dimension insofar as Smith wanted to outline theories that explain economic phenomena. His *Wealth of Nations*, however, is full of historical commentary and reflected a strongly normative-sociological purpose: the identification of the social, historical, and ethical conditions that permitted the establishment and maintenance of the civilization of natural liberty that Smith believed was good for all people. This project necessitated directing attention to how and why certain institu-

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85. FRANZ BÖHM, WETTBEWERB UND MONOPOLKAMPF, at xi (1933).

86. *See* KNUD HAAKONSSEN, THE SCIENCE OF A LEGISLATOR: THE NATURAL JURISPRUDENCE OF DAVID HUME AND ADAM SMITH 61–62 (1981).

87. 1 ADAM FERGUSON, PRINCIPLES OF MORAL AND POLITICAL SCIENCE 2 (Jean Hecht ed., Georg Olms Verlag 1995) (1792).

tions and habits had developed to protect and support these liberties. The descriptive and normative dimensions of Smith's political economy are consequently deeply intertwined. There is no doubt that Smith considered utility to be something that intellectual inquiry could not ignore. But liberty and virtue were similarly indispensable if people were to engage in human flourishing.[88] As Ryan Patrick Hanley observed, "it is largely recognized today that the model citizen of Smith's commercial society resembles less an interest-maximizing caricature of *homo economicus* . . . than the more moderate, sober prudent man described in [*The Theory of Moral Sentiments*]."[89] In short, Smith and other Scots sought a judicious integration of positive analysis with the promotion of particular normative goals.

Economists wishing to re-engage economics in a wider discussion about the truth of human reality could thus do worse than return to the writings of Adam Smith. Here one finds a truly synthetic approach to comprehending not just the economic dimension of human reality, but also how that economic component fits into a fuller picture of human reality—one that is committed to treating moral virtues as real to the same extent as the forces of entrepreneurship and peaceful free exchange, not to mention institutions such as the rule of law that are the very stuff of modern flourishing economies. Returning to Smith does not imply wholesale abandonment of all the tools and methods developed in a range of different schools of economic thought since 1776. It does, however, suggest that efforts to quarantine economic science from normative considerations or even knowledge of the basic moral goods knowable by human reason ought to be themselves viewed as unreasonable and unscientific.

CONCLUSION

Obviously, rethinking the scope and emphasis of economics along the lines suggested here would involve rather significant changes in the teaching of economics and in our expectations about what the discipline can yield in terms of human knowledge. This task is difficult because neither economics nor

88. *See* HANLEY, *supra* note 80, at 34–35.
89. *Id.* at 112.

economists have proved immune to the effects of the hyper-specialization that characterizes so much of contemporary university education. The ability to engage in this type of economic research—to integrate positive technical analysis with knowledge acquired from other disciplines—requires a sophisticated knowledge of fields outside positive technical economics. Yet integration may be only half the challenge for contemporary economics. If the 2008 financial crisis has taught us anything, it is that economists, business executives, politicians, and bankers—indeed, all of us—need to cultivate a range of moral and intellectual habits (especially humility) that inform the use of technical skills. Although Keynes was much criticized by Röpke for his impact on the character of postwar economics, one suspects Röpke would have agreed with Keynes's famous description of the talents required to be a good economist—one that is just as relevant today in a post-crisis world:

> [T]he master-economist must possess a rare *combination* of gifts. He must reach a high standard in several different directions and must combine talents not often found together. He must be mathematician, historian, statesman, philosopher—in some degree. He must understand symbols and speak in words. He must contemplate the particular in terms of the general, and touch abstract and concrete in the same flight of thought. He must study the present in light of the past for the purposes of the future. No part of man's nature or his institutions must lie entirely outside his regard. He must be purposeful and disinterested in a simultaneous mood; as aloof and incorruptible as an artist, yet sometimes as near the earth as a politician.[90]

90. John Maynard Keynes, *Alfred Marshall, 1842–1924*, 34 ECON. J. 311, 322 (1924).