

Opinion **Free Lunch**

What macroeconomists actually do

Problems can be traced back to two intellectual revolutions

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What do macroeconomists actually do? Without an answer to that question, it is difficult to articulate what they might be doing wrong. The [rebuilding macroeconomic theory project](#) is useful also to non-economists — perhaps especially to them — because it takes the time to dwell on how macroeconomists do what they do, in order to argue what they must do better.

Another way of saying this is that the history of changing macro is the history of macro methodology. As the project's introductory article by Vines and Wills [narrates](#), today's troubled macroeconomics is the result of two intellectual revolutions.

The crucial methodological move by Keynes in the 1930s was a theory of the economic system in which everything depends on everything else rather than the prior practice of simply juxtaposing separate analyses of the key markets (for labour, goods, and money). Without this move it was impossible even to conceptualise the notion of a shortfall in aggregate demand as a cause of unemployment. In the jargon, he moved from partial to general equilibrium.

The crucial methodological move in the 1970s was to reject models that produced policy options that relied on “fooling” participants systematically about the economic consequences of given policy interventions. The new tenet, to satisfy the so-called Lucas critique, was that models must involve private decision makers doing the best they could according to their own interest in light of forward-looking expectations that should not be systematically wrong — and no less correct than the beliefs of policymakers themselves. In the jargon, this is the requirement that models have proper “microfoundations”.

This, too, had implications for what it was possible to conceptualise within the new standard models. For example, it entailed that there is a (single) natural rate of unemployment, and as Paul Krugman says in [his contribution to the project](#), “basically everyone accepted the natural rate idea, abandoning the notion of a long-run trade-off between inflation and unemployment”. The implications for the proper purposes of fiscal and monetary policy are huge — and to a large extent negative, in that they limit the plausible good these can have for the economy. How tight these limits are depends on modelling choices within the overall “microfounded” framework.

There are two important truths to recognise here. One is general: methodology matters. It matters because it shapes, directs and to some degree constrains the answers economic research can produce to important questions of policy. It can even shape the sort of questions that can be profitably pursued in the first place. By “profitably” I have in mind what questions the methodological framework can fruitfully address, but also what questions researchers are rewarded for pursuing. In a [scathing critique](#) of the “microfoundations hegemony” Simon Wren-Lewis complains that “non-microfounded models [were] eventually excluded from the top journals”, with implications for the prestige, career advancement, and funding for researchers using other kinds of analysis.

The second important truth concerns specifics: the precise constraints the dominant methodology imposes, how serious a problem they are, and how they could or should be lifted. Here the rebuilding macro theory project is perhaps the most illuminating as it showcases wide disagreement among the contributors.

These differences go into the detailed modelling choices, and uninitiated but interested readers may benefit from a grasp of the overall structure of the standard model — because (macro) economics is too important to be left to (macro) economists only. At the core of macroeconomic research is the DSGE model, so-called because it is Dynamic (it describes an economy evolving over time and models decision makers as acting on expectations of the future), Stochastic (it includes random fluctuations or “shocks” to the economy) and General Equilibrium (everything depends on everything else).

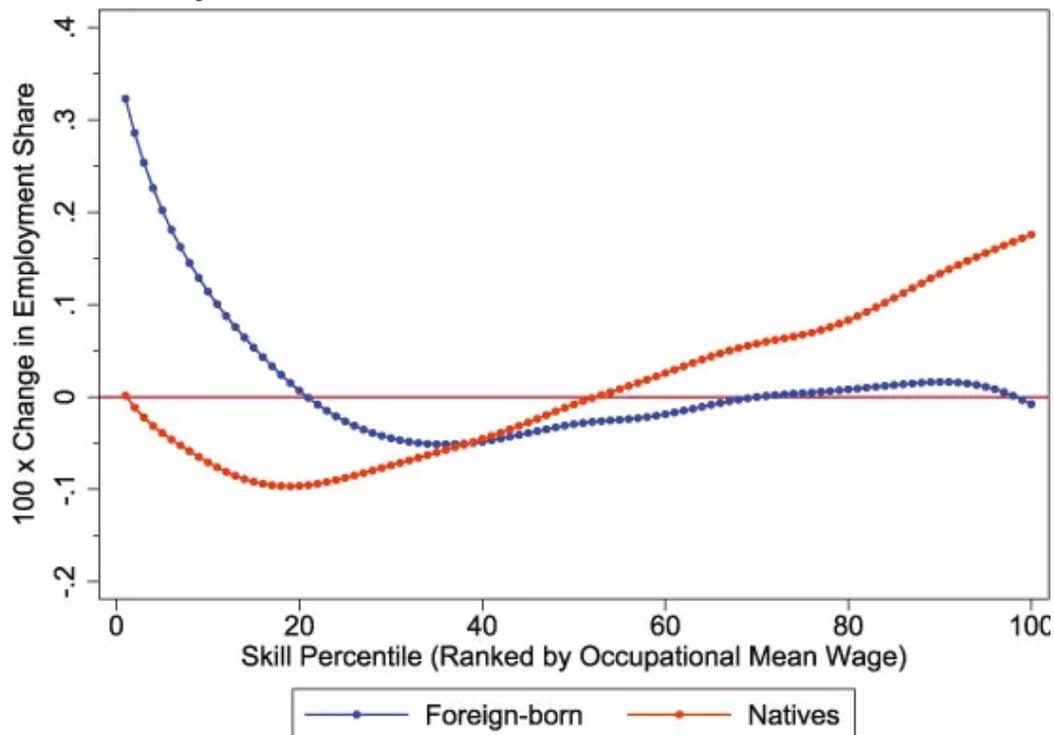
For those who don’t do economic modelling but want to understand what it actually involves, the New York Fed has produced a [guide to what a DSGE model is](#) and how policymakers use it. The introductory article by Vines and Wills in the Rethinking Macroeconomics volume also gives a [verbal overview of the state of the art model](#) used by the European Central Bank, as well as the basic mathematical content.

But in very crude terms, a DSGE model contains equations representing individuals’ choices to consume and save; companies’ choices to produce and invest; and the central bank’s setting of nominal interest rates. Upon this skeleton, modelling choices can be added about all kinds of things (how companies set prices; how work and hiring decisions are made; other policy choices and so on). The model is solved or estimated as a complicated system of many equations, often requiring simulations, simplifications or shortcuts to approximate a solution. Much work in macroeconomics lies in refining the basic model to make it more fit for purpose.

Whether this can be adequately done depends on what that purpose is; how far a “refinement” can stretch the structure; and what criteria modelling choices are and should be judged by. It is in these questions we are going to see the real heat of the intellectual conflict.

Other readables

- A new study of immigration and job markets in the US [reaches a counterintuitive conclusion](#). Low-skilled immigration may have created more middle-class jobs for natives than would otherwise have been the case. This is because immigration to some extent offsets the process of automation, which "hollows out" the middle of the jobs distribution, by overwhelmingly filling the new low-skilled jobs. The faster growth this made possible preserved more mid-range jobs for natives. Decomposing the changing composition of jobs (see chart below) since 1980 shows that the polarisation into more low-skilled and high-skilled jobs but fewer mid-range ones was a phenomenon confined to the immigrant population; natives on average moved from worse to better jobs.



- The impeccably informed Alex Barker reports on the [new demands](#) the EU is preparing to make in return for granting the UK a standstill transition period after Brexit.

Numbers news

- Politico has gone through the EU's [thorough region-by-region mapping](#) of which localities of Europe stand to suffer the most economic harm from Brexit.