

WHY DO PEOPLE BELIEVE STUPID ECONOMIC IDEAS?*

***DESPITE BUCKETS OF EVIDENCE TO THE CONTRARY...**

**Mark Blyth, Eastman Professor of Political Economy, The Watson Institute at Brown University
Volatility and Tail Risk Conference, London, April 6th 2017**

DEFINITION OF A STUPID ECONOMIC IDEA

A STUPID ECONOMIC IDEA IS ONE THAT IS IMMUNE TO EMPIRICAL REFUTATION WHILE BEING USEFUL TO SPECIFIC CONSTITUENCIES

EXAMPLES



THE BOLD IDEA OF AUSTERITY

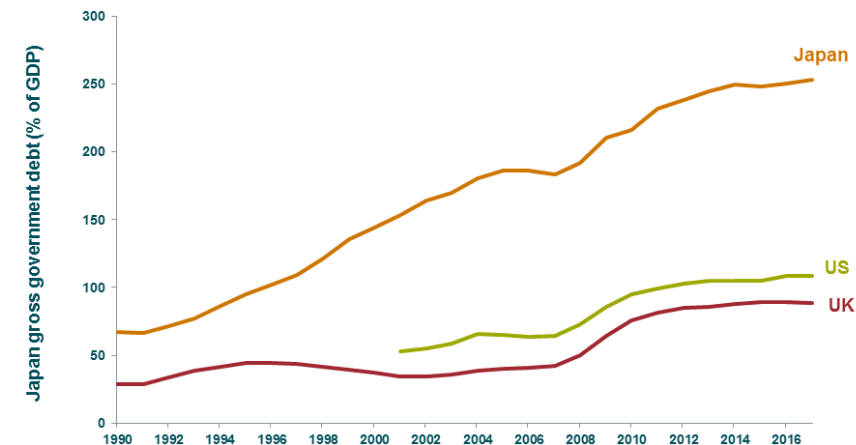
- **AUSTERITY – CUTTING THE STATE'S BUDGET NOW LEADS TO GROWTH TOMORROW INVESTOR CONFIDENCE**
- **THE STATE'S BUDGET AND THE FAMILY BUDGET**
- **REALITY – THE IKEA PROBLEM**
- **CRITICAL CASE: GREECE**
- **QUI BONO? CREDITORS AND OVER-LENDERS**



TURNING JAPANESE: THE FEAR OF GOVVIES GOING BAD

Figure 3: An illusory measure

Japan gross government debt (% of GDP), IMF data



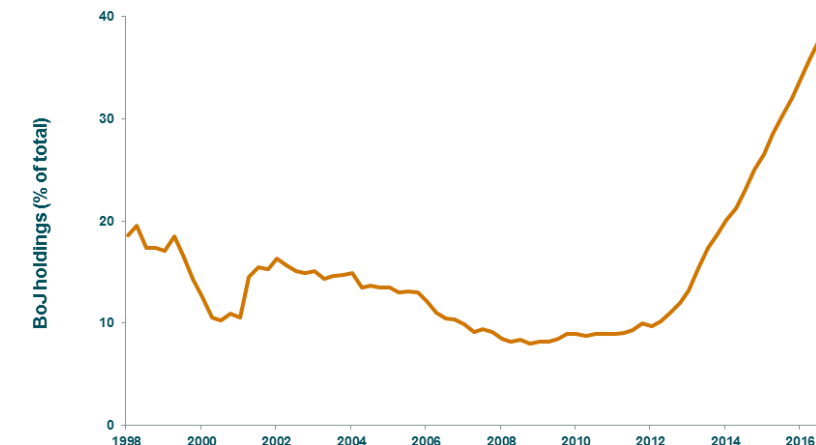
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M&G
INVESTMENTS

3 Source: Datastream, February 2017

Figure 4: Whose asset, and whose liability?

Japanese Government Bonds and T-Bills held by Central Bank (% of total)



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INVESTMENTS

4 Source: Bloomberg, February 2017

THE INFLATION PUZZLE

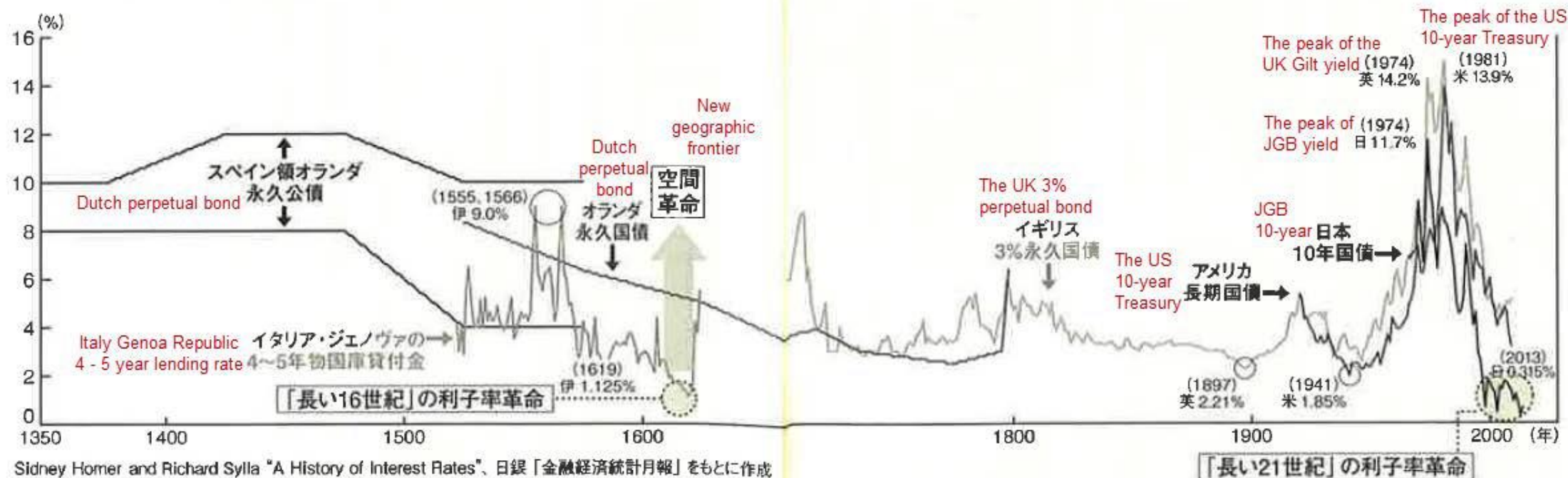
- **\$13T IN LONG DATED DEBT PLUS \$13T IN CENTRAL BANK INTERVENTION**
- **GLOBAL LONG RUN RATE OF INTEREST IS AROUND 1.5%**
- **WHAT MATTERS FOR INFLATION IS LABOR POWER AND DEGREE OF OPENNESS**
- **QUI BONO? OPEN QUESTION**



MISUNDERSTANDING THE 1970S: INTEREST RATES OVER THE VERY LONG RUN

Source: Kazuo Mizuno (the former Japan Cabinet Office Economic Advisor) and Capital World Investors via Tomonori Tani.

図1 経済覇権国の金利の推移



THE END OF THE SERIES: US FED FUNDS RATE 1970-2017



WE ARE GOING TO STAY LONG AND LOW FOR A LONG TIME

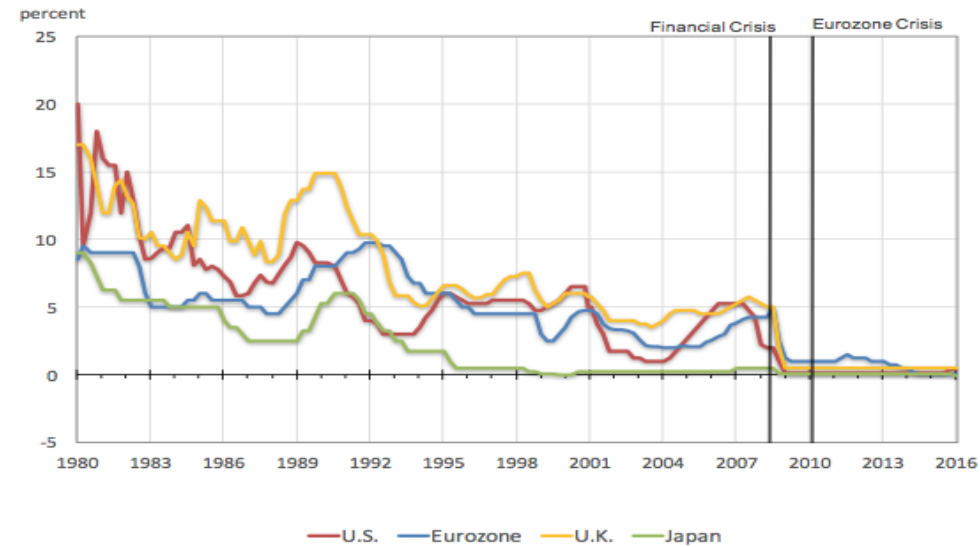


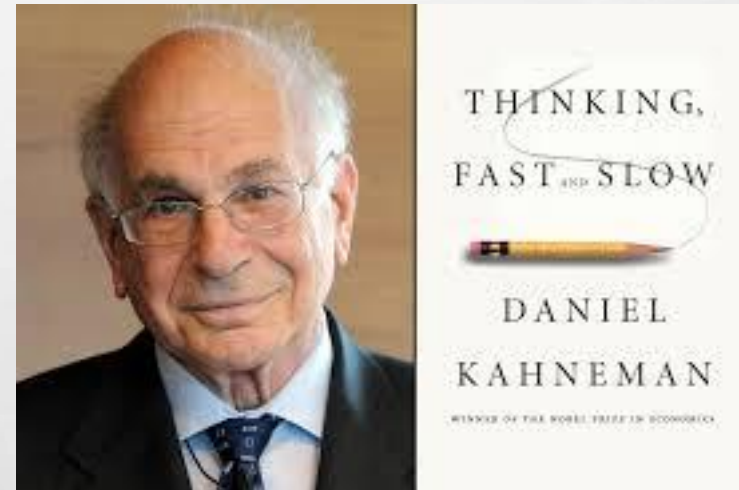
Figure 1: Policy Rates, Eurozone, Japan, U.S. and U.K., 1980-2016. Sources: U.S.: Federal Funds Official Target Rate; Eurozone: until Dec. 1998, Germany's Lombard Rate. After 1998, ECB Marginal Rate of Refinancing Operations; U.K.: Bank of England Base Lending Rate; Japan: Bank of Japan Target Call Rate. Data from Global Financial Database.

**WHAT DRIVES US TO
IGNORE FALSIFICATION?**



WILLFUL BLINDNESS

- **SELF SELECTION VIA FILTERS AND BIASES (KAHNEMAN AND TVERSKY)**
- **IDEOLOGY (IDEA OF MARKET FAILURE)**
- **EPISTEMIC COMFORTS OF HOME (HARDIN)**
- **RELIGION (GUILT/SCHULD/CREDERE/CREDIT)**
- **RATIONAL IGNORANCE (OLSEN)**



BEING A MUPPET?



- **TALKING OUT ONE'S BACKSIDE (GALBRAITH ON THE 1920'S BUBBLE)**
- **NO PAYOFF TO CALLING UNCLE IF UNCLE HAS THE CASH**
- **MARKET IRRATIONALITY V'S PERSONAL SOLVENCY**

PERVERSE INCENTIVES

- **UPTON SINCLAIR ON A MAN'S JOB**
- **INSTITUTIONAL PRO-CYCLICALITY (HOW TO LOSE A GOOD JOB IN FINANCE)**
- **NORMAL ACCIDENTS AND SYSTEM BLINDNESS (PERROW)**

"IT IS DIFFICULT TO GET A MAN TO UNDERSTAND SOMETHING WHEN HIS SALARY DEPENDS UPON HIS NOT UNDERSTANDING IT."

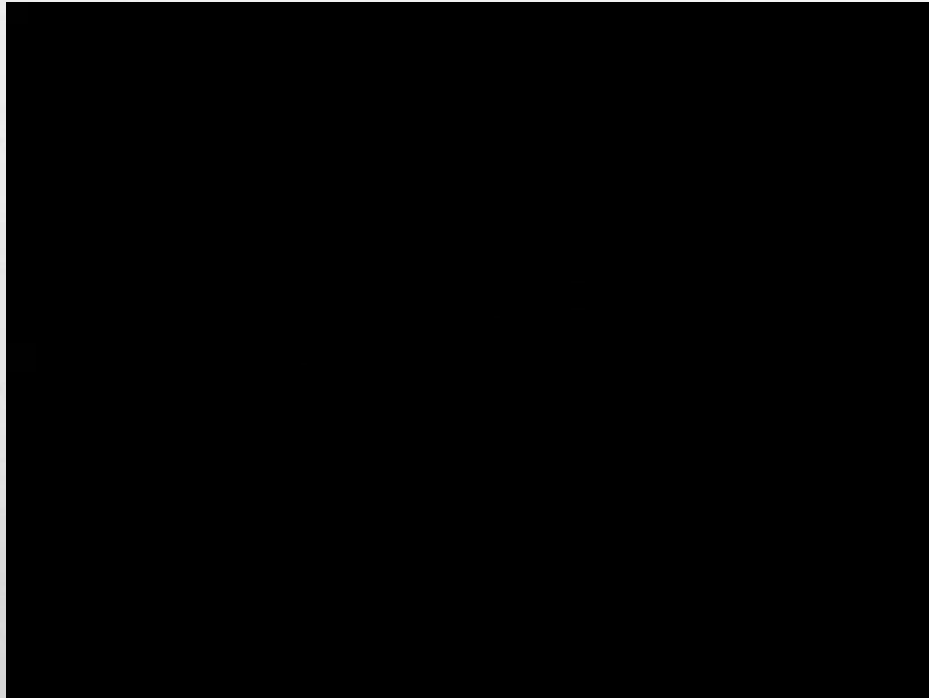
UPTON SINCLAIR

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THE HARDER STUFF

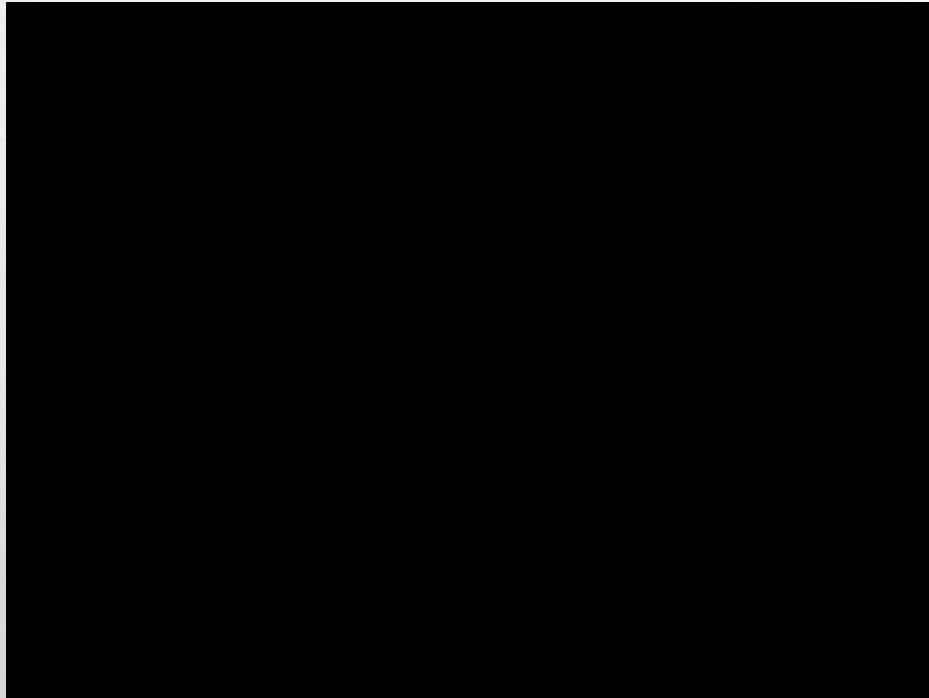


ANYTHING MACRO



- **ENTRAINMENT AND TIGHT COUPLING (WE ONLY SEE THE COMPONENTS)**
- **FALLACIES OF COMPOSITION (THE ARTHRITIC HAND)**

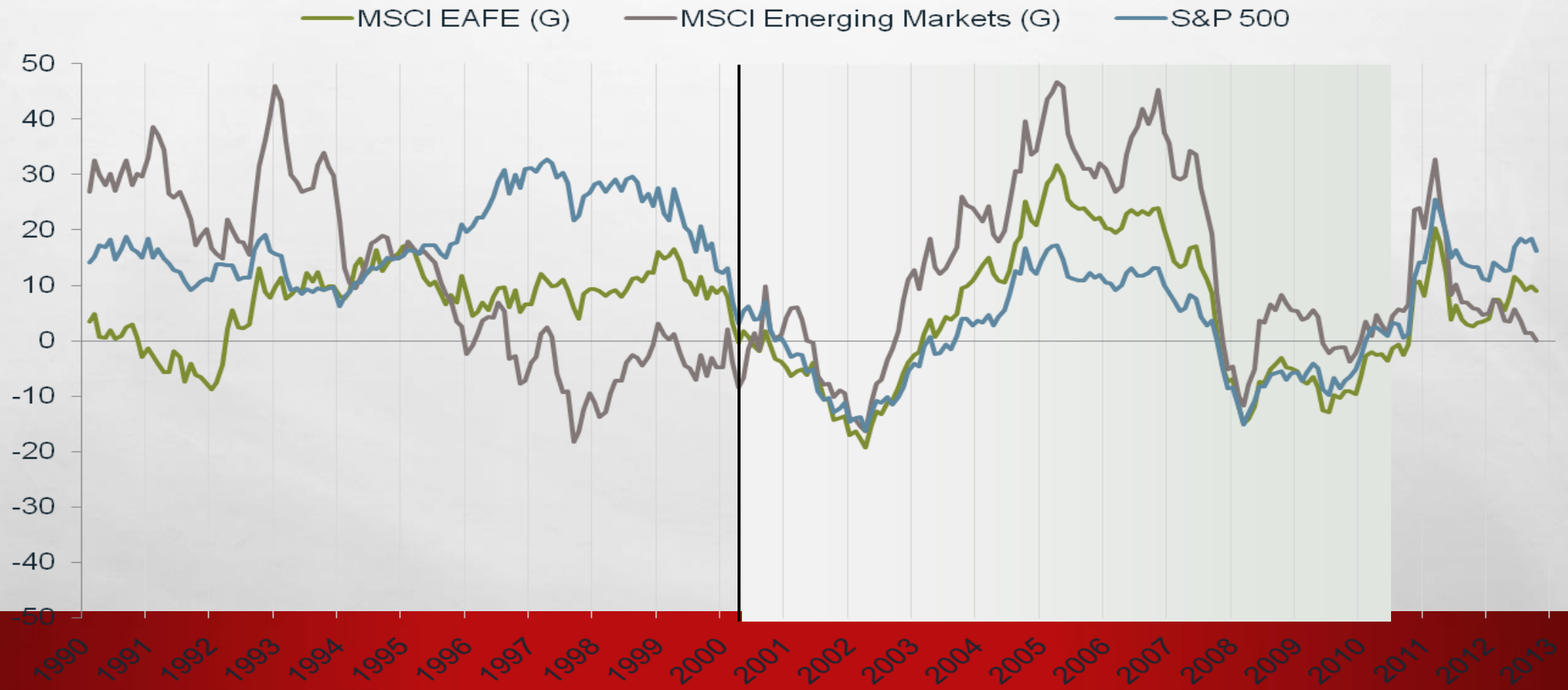
NON-LINEAR SYSTEMS



- **PREFERENTIAL ATTACHMENT AND HIDDEN CORRELATION**
- **TRAFFIC JAMS WITH NO ACCIDENTS**
- **CORRELATION ACROSS FINANCIAL INDEXES**

CORRELATION AS PREFERENTIAL ATTACHMENT

36-Month Moving Average of Three Major Market Indices



TAIL RISKS AND VOLATILITY

- **STALKING THE BLACK SWAN?**
- **PLAYING RUSSIAN ROULETTE WITH A DRUNK SCOTSMAN (SAMPLING)**
- **ENDOGENEITY BLINDNESS (CAUSAL POLITICS)**
- **IS THE WHOLE WORLD SHORT VOL?**

THIS WEEK IN GEOPOLITICS

Stalking the Black Swan with George Friedman

Nationalism, the United States, and Cyclical Crises

Jan 02, 2017

By George Friedman and Allison Fedirka

In the coming year, the United States will remain the overwhelmingly dominant geopolitical power in the global system, and President-elect Donald Trump will be at the helm. His presidency will mark a turning point as the first significant shift towards nationalism at the center of the US political system.

As [explained in our 2017 forecast](#), this rise in nationalism is a global trend, and one of three critical consequences of the 2008 financial crisis that will play a pivotal role in shaping geopolitics in 2017. (The other two are economic stagnation and instability in export-dependent countries.) Its rise stems from [the rejection of the internationalist model](#) that has dominated international relations since the end of World War II.

In places like Europe, it is easy to see why [internationalism is losing favor](#). It is less obvious for the US. The European Union (EU) put in place policies and regulations

THE INSISTENCE ON MICROFOUNDATIONS

- **DSGE MODELS AND CENTRAL BANKS**
- **THE IMPOSSIBILITY OF RATEX**
- **THE REALITY OF TOO MUCH INFORMATION**



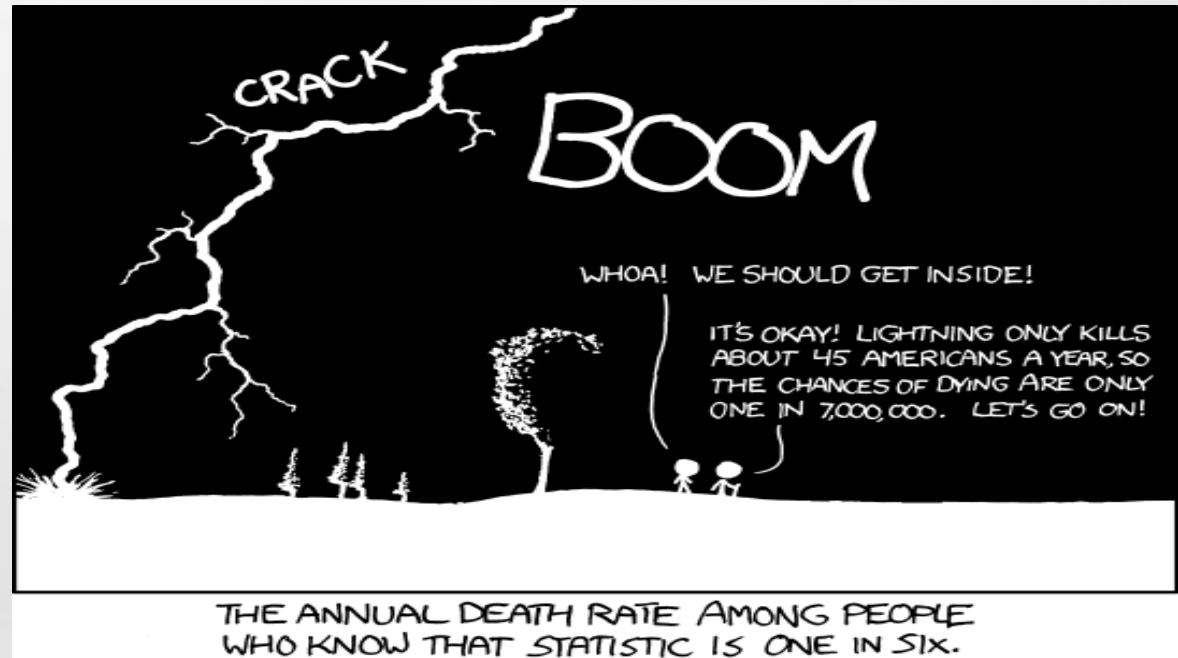
Everything reminds Milton of the money supply.
Well, everything reminds me of sex, but I keep it out
of the paper.

(Robert Solow)

izquotes.com

SO HOW DO WE COPE WITH TOO MUCH INFORMATION?

- **ECONOMIC IDEAS AS COORDINATION DEVICES**
- **'FUNDAMENTALS' AS A SOCIAL CONVENTION**
- **ECONOMIC IDEAS (EVEN BAD ONES) REDUCE UNCERTAINTY**
- **BUT...IN USING STUPID IDEAS WE BUILD ENTRAINMENT AND COUPLING (VOL SUPPRESSION) INTO THE SYSTEM**



A Map of Economic Change

System complexity and degree of Entrainment (second-order correlation)

Institutional Correlation Across System

	Loose Coupling	Tight Coupling
Low Complexity/Low Entrainment	<p>Linear Interactions with Buffers Hard to Transmit Shocks</p> <p>Example: The Full Employment Regime prior to 1970s</p>	<p>Linear Interactions without Buffers Easier to Transmit shocks but low multiplication of impulse</p> <p>Example: The 1970s Inflation and end of the Full Employment Regime</p>
High Complexity/High Entrainment	<p>Non-Linear Interactions with Buffers Lower volatility but with unobservable risk building</p> <p>Example: The Low Inflation Regime prior to 2008</p>	<p>Non-Linear Interactions without Buffers Strong convexities, serial correlation across systems, impulse multiplied</p> <p>Examples: The GFC of 2008 and 2016 Global Populism</p>

A Map of the stupid ideas underlying those changes

System complexity and degree of Entrainment (second-order correlation)

Institutional Correlation Across System

	Loose Coupling	Tight Coupling
Low Complexity/Low Entrainment	<p>Linear Interactions with Buffers Hard to Transmit Shocks</p> <p>Example: The Full Employment Regime prior to 1970s</p> <p>Ideas: Phillip's Curve Keynesianism</p>	<p>Linear Interactions without Buffers, Easier to Transmit shocks, low multiplication of impulse</p> <p>Example: The 1970s Inflation and end of the Full Employment Regime</p> <p>Ideas: Monetarism</p>
High Complexity/High Entrainment	<p>Non-Linear Interactions with Buffers, Lower volatility but with unobservable risk building</p> <p>Example: The Low Inflation Regime prior to 2008</p> <p>Ideas: The Great Moderation</p>	<p>Non-Linear Interactions without Buffers, Strong convexities, serial correlation across systems</p> <p>Examples: The GFC of 2008 and 2016 Global Populism</p> <p>Ideas: QE, Austerity, Neo-nationalism</p>