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The Financial Crisis and the Death (or Hegemony) of Development Economics

Raghuram Rajan

*Development economics* was the study of how to create the plumbing that would allow developing economies to become developed. The financial crisis leads us to question whether industrialized countries have the plumbing problem solved and thus leads us to question whether we need a development economics that is separate from macroeconomics. Indeed, it even leads us to question whether development economics should take as its goal the creation of the institutional plumbing that industrialized countries currently have. The consequence will be a blending of concerns that have been central in developing economies with the standard macro models. The blending can be seen as either the death of development economics or the hegemony of development economics.

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In deciding what to entitle my talk, I debated between “The Financial Crisis and the Death of Development Economics” and “The Financial Crisis and the Hegemony of Development Economics.” I think that either of these titles would have worked. Let me explain. In some sense, you can think of macroeconomics before this crisis as assuming that the “plumbing” works. That is, there is a whole lot of institutional plumbing that goes into the economy, and generally that plumbing works. This means that we did not have to focus on the plumbing in research or in teaching the macroeconomics of industrialized countries. That left room for a separate field of development economics, which was the study of how to create the plumbing that would allow the developing economy to become developed. The financial crisis leads us to question whether industrialized countries have the plumbing problem solved and thus leads us to question whether we need a development economics that is separate from macroeconomics. Indeed, it even leads us to question whether development economics should take as its goal to create the institutional plumbing that industrialized countries currently have. The result will be a blending of concerns

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that have been central in developing economies with the standard macro models. The blending can be seen as either the death of development economics or the hegemony of development economics.

To be fair to the view that the plumbing works, it does not deny that problems can exist in the plumbing. For example, it recognizes that there are incentive-compatibility, agency, and similar problems with the financial plumbing. But the assumption within the standard macroeconomics model is that most of those problems can be considered as second-order problems in an industrial economy. The reason these problems do not undermine the plumbing is because we have a framework of institutions that provide checks and balances.

Once we assume that the plumbing works, we can focus the analysis at a more macro level. We do not need to deal with the contracts between people, such as the incentive structure between an employer and employee. The problems these issues raise become second order. This allows us to get down to a frictionless representative agent model and deal with some of the issues that that frictionless framework raises, such as how incentive matters across time.

Using the frictionless representative agent framework, we get a lot of irrelevance theorems both in finance, such as the Modigliani Miller theorem, which shows that the capital structure of firms doesn’t matter; and in macroeconomics, such as the Ricardian equivalence theorem, which suggests that it does not matter whether the government finances its spending by taxes or bonds. All these irrelevance theorems give one the sense that policy does not matter much. For examples, Ricardian equivalence suggests that the effects of government spending are limited.

The “plumbing works” approach created a view within economic research about what was appropriate and what was ad hoc. The starting point was an Arrow Debreu world, and we departed from it only by making ad hoc assumptions. So, for example, there was a sense that the whole incomplete-contract literature started by Sanford Grossman and Oliver Hart (1986) was to some extent ad hoc because it assumed incompleteness. Thus it was not really serious research.

Now, of course, the Arrow Debreu world is a very special world in which all the contracts can be enforced by some entity that we do not actually see. It is only a bit of an exaggeration to say that the “plumbing works” approach is where researchers thought they were when thinking about an industrial economy. Development economics was different: it considered plumbing issues. However, it too was influenced by this Arrow Debreu thinking. By that, I mean that it considered plumbing issues, but it considered them in a particular way. It focused the analysis on copying the institutions of the industrialized economies so that developing countries had an institutional structure that would protect property rights, and provide the plumbing that would give the right incentives, so that the private sector could then be left alone to generate prosperity.

The whole point of development economics in recent years has been focused on teaching poor and emerging economies the process of creating that institutional structure. There has been a huge amount of debate within development and growth economics about how those institutions get created; whether they are a colonial legacy or whether they are determined by other forces in history such as technology. But there has been little debate about whether those are the institutions that developing countries should be striving for. The assumptions were that it is possible to get to the point where these countries will have the institutional framework they need and that they should be striving to achieve that framework. Once countries achieved the framework, they would have reached the end of development economics history. They would then move to a different area of economics; the area where the plumbing worked—industrial country macroeconomics.
Once countries left the development stage, most policy became irrelevant within the models. The only way in which you could get policy to matter in the models was by adding ad hoc frictions to the model. For most researchers, adding those ad hoc frictions did not have popular appeal. Economists’ irrelevance theorems did not, however, end policy in government. In fact, they had the opposite effect because practical policy discussion at the government level never moved far beyond Keynes in terms of policymaking. Even today, the discussion is still about how much expenditure to use to stimulate the economy and when that expenditure should be made. Of course, the models that specialists in the Federal Reserve or the European Central Bank use have significant neoclassical components, but the language of discussion at the highest levels is uniformly Keynesian.

Because of the irrelevance of irrelevancy theorems for practical policy, I think that the people who complain about the modern model’s having led us to the current problems get it wrong. For example, when Paul Krugman points out important problems with neoclassical economics and then argues it got us into this crisis, he skips over an inconvenient fact. Since policymakers were largely slaves of Keynes, you cannot blame modern neoclassical economics for the problems. Modern neoclassical economics and its abstract models have not really been followed in government since they were invented.

This is not to say that the neoclassical model makers are blameless. It is only a slight exaggeration to say that there is almost nothing for the government to do in these neoclassical models in which the underlying plumbing works and people see through everything that the government is trying to do. If the problem is in the plumbing, and if the models assume the plumbing away, then the models did not provide policy guidance, so policymakers are naturally going to look elsewhere.

MACRO POLICY WHEN THE PLUMBING DOES NOT WORK

What the financial crisis has taught us is that, at times, the plumbing does not work very well enough. Somehow, even in the most sophisticated industrialized economies of the world, the plumbing can break down. This means that the policy irrelevance theorems that we had assumed carried over from the models to policy do not carry over. Somehow, the capital structure of institutions mattered. Investment banks, which had a leverage of 40 or 50 to 1, found that they had a problem in refinancing, and people started worrying about what banks had on their balance sheet. As an example, my colleague, Douglas Diamond (1984), has written the major papers on banking theory. When he went out on the job market with his paper on deposit runs, there were a number of places where he was asked, “Why are you doing banking history? Bank runs are something that happened in the nineteenth century, and perhaps in the Depression, but this is history now.” The feeling was that we were beyond considering such issues.

What the financial crisis has taught us is that we have not moved beyond such issues. The same problems still affect us, which suggests that this view that institutions progress to the point where we can get effective enforcement and we do not have to worry about them any more is wrong. This puts industrialized countries in the same position as developing economies: both have to pay attention to the plumbing. We can never forget the plumbing; there is no end of history as far as development economics is concerned. Either it is all development economics, or none of it is development economics.
DOING RESEARCH AND TEACHING ABOUT PLUMBING

What does all this mean in terms of the way we do research? I think it tells us that we have had a bit too strong a tendency to start from the perfect Arrow Debreu world and to then add frictions. I think that approach is now called into question. I think it suggests that we would be better off by starting the analysis of the economy as one with no institutions: an anarchic economy, where nothing is enforced. The analysis would then turn to explicitly considering the building up of institutions that enforce contracts.

This approach that I am suggesting sounds a lot like development economics, and in many ways it is. We should start our teaching and our model with thinking about how a poor country without institutions actually sets up the beginnings of an economy, how that economy then develops over time, and how those institutions actually become effective. What I am suggesting is that development economics takes over everything in our teaching and in our research. But such a takeover also can be seen as the death of development economics because if economics considers such issues, there is no need to have a development economics. There is only economics.

THE SITUATION IS NOT AS DIRE AS IT SOMETIMES SEEMS

While I do believe that there is a need for a change in research and teaching, the situation is not as bad as it sometimes seems. Specifically, I think there is an impression out there in the public that economists do not know anything about the things that happened during this crisis. That would be wrong. The truth is that the areas of economics that most of the public comes in contact with had some things right. For example, during the great moderation, economists were right to assume away the details of the plumbing and had some important insights to add about the economy.

My argument is not that we have to dump everything we have done before: rather, we need to supplement that analysis with analysis based on other areas of economics that have looked at the plumbing. For example, in the banking and finance literature, there are many papers about short-term debt and liquidity constraints, about aggregate liquidity shortages. These all have been areas of vibrant research in the last 10–15 years. Many economists do understand what happened during this crisis at the micro finance level.

Once we start paying more attention to the plumbing, macroeconomics will reach out and will continue to reach out to these other areas; it will incorporate this work into the macroeconomics models. This means that the models are going to become much less parsimonious; they are going to be messier and more complicated. That is the price that will have to be paid for the greater recognition that plumbing matters.

JUDGING ECONOMICS FROM AN EX ANTE FRAMEWORK

In his accompanying article, Ben Friedman made the point that bankers and economists deviated from reality in not even conceiving that the crisis might be coming. I think that argument can be overstated. There are a lot of things that from the point of view of a crisis look incomprehensible. One can look back and ask this: What were they smoking to have done what they did? Anyone in their right mind knows that housing prices can fall. But I do not think the ex post question is the appropriate question. The appropriate question to ask is an ex ante question, not an ex
post question. With the benefit of hindsight, lots of things look really foolish, including anyone holding stock during this period. I do not believe that this holding stock ex ante was foolish.

Another example of things looking different ex post than they did ex ante involves Citibank, which was pushed by some very influential policymakers into taking more risk. Clearly, in hindsight, this looks like a terrible decision, but if you think about that period when Citibank was making this judgment, there was a lot of money to be made in the market, the government wanted these businesses to flourish, and the Fed had put out an effective insurance policy, implicitly guaranteeing that if, in fact, things collapse, it would come in and ease things over until the next expansion. My point is not that it made perfect sense; my point is that you cannot argue it was completely crazy to have increased risk during this time period. Evidence suggests that in 2006, the banks that took the largest risks experienced the highest returns (see Beltratti and Stulz 2009). Was the market irrational? Maybe! But it also might have been simply putting a low probability on a crisis and putting a high probability on the continuation of profits that they were making. So I think other issues besides irrationality have to be seen as causes of the crisis.

Let me offer one more example of the problem of judging policy with the benefit of hindsight. Consider my home country, India, where there has been a lot of talk about how India was so astute in having a very conservative central bank, which did not allow liberalization of the financial sector, allowing it to escape the worst of the financial crisis. This can lead to the conclusion that conservatism is a good thing. Now, true, given the worst financial crisis in 75 years, conservatism was a good thing in the sense that it helped avoid the crisis. But that is not the relevant question. The relevant question is: Was it a good thing ex ante, without the benefit of hindsight? That is the question because unfortunately we do not have hindsight when we make policy. Equivalently, would it be a good thing now going forward? In my view, the answer to that question is not so clear—there are both gains and losses, and both must be considered.

CONCLUSION

There were matters that were inadequately grasped by macroeconomics research and hence inadequacies with the teaching of macroeconomics. We had not integrated an analysis of the plumbing into the standard economic models, so when the plumbing broke down, the models were not a lot of help. It is now clear that we need to integrate a consideration of the plumbing into our models and our teaching. In doing so, we will be blending development macroeconomics into standard macroeconomics. That blending would be a good thing. Standard macroeconomics would become less parsimonious, but more useful.

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