Where were you?

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> "Inspiration is most likely to come through the stimulus provided by the patterns, puzzles and anomalies revealed by the systematic gathering of data, particularly when the prime need is to break our existing habits of thought" Ronald Coase, Nobel Prize lecture (1991).[1]

All too few academic economists these days seem to be engaged in policy debates, and that seems especially true in the UK. Maybe that is because of perverse incentives because promotion and reputation rest in large part on publication in prestigious journals that few people read. That may well be because the Research Assessment Exercise (RAE)/Research Evaluation Framework (REF) in the UK amounts to little more than top journal paper counting.[2] Sadly many of these papers are cited by few and are not written to solve a deep policy question and indeed, in some cases could even be summarised as an answer in search of a question and worthless. A 'major' contribution on a totally trivial technical point in the economics profession usually receives more approbation and attention, and even a salary increase than a small contribution to an important question. Trying to solve some narrow theoretical point may well be less than useless. The big emphasis on theory in many UK economics departments seems to have been a mistake as it seems to have little impact and has done little or nothing to improve the human condition. Playing clever mind games which is the equivalent of counting angels on pinheads should be a hobby rather than an activity subsidised by the British taxpayer.[3]

Andrew Oswald (2006) examined citations in journals and found that the journal system often allocates high-quality papers into medium-quality journals, and vice versa. In the American Economic Review, which is perhaps the most famous journal in the discipline, he found that in its winter issue in 1981 more than one third of the issue's articles had after a quarter of a century each been cited fewer than 20 times.[4] The very best papers in the other lower quality journals had by then garnered far more mentions in others' bibliographies. Oswald concluded that "it is dangerous to argue that publication in famous journal X means that a paper is more important than one published in medium-quality journal Y."

Unless research is addressed at important policy questions the general public is entitled to feel they are not getting decent value for their investment. The money likely would have been better spent delivering free child care. I advise vice-chancellors and deans these days to ask every economist they interview the following question "what problem is your research attempting to solve"? Can't answer or unsatisfactory response, don't hire, period. It's perfectly OK to say that what is being examined is a hard question that may take a long time to solve but it is not enough to say that what is being studied is how to add a squiggle to a squiggle. The university would be

[1] Coase, R.H. (1991), 'The institutional structure of production', American Economic Review, 82, pp.713-719.

[2] Andrew Oswald has argued that such exercises 'lead to short-term thinking; they make researchers focus on the names of journals rather than on ideas'. http://andrewoswald.com/docs/oswaldraejan09.pdf

[3] See Diane Coyle's Tanner lectures 'The public responsibility of the economist", 2012 for interesting insights into the failings of both economics and economists in the Great Recession.

[4] Andrew J. Oswald, 'An examination of the reliability of prestigious scholarly journals: evidence and implications for decision-makers' IZA Discussion Paper No. 2070, April 2006

better off hiring someone who is working on how to cure cancer or ALS that my father died from recently.

Sitting at the Bank of England as a member of the Monetary Policy Committee from 2006-2009, trying to make interest rate decisions every month was a lonely task; there was little or nothing academic economists had to contribute, I am afraid to say. I also learnt about the extent to which academic economist are not really engaged in the current policy questions. A major issue in 2008 was whether or not the labour market was tightening or not; none of my labour economist colleagues had been thinking about that. There were many more such issues that I needed help with but was left high and dry as the academic economics community is not engaged in the big economic questions of the day

I am struck how data releases drive the lives of economists out there practising in the real world and how little academic economists know about what they do. My life these days is very much based around data releases of the monthly unemployment and inflation numbers, the quarterly GDP numbers for the UK and the USA and Europe, as well as reports by the Bank of England's agents; the EU monthly sentiment Index; the Nationwide house price consumer confidence and house price indices; the Lloyds/HBOS house price Index and the three Purchasing manager's Indexes for Manufacturing, construction and services that come out on the first three days of the month, in that order. Plus there is stuff from the Bank of England on lending and the money supply each month. Then there are the quarterly Industrial Tends and Distributive Trades Surveys from the CBI and the quarterly survey from the British Chambers of Commerce. And that is only for the UK, there are indices for Europe on unemployment from Eurostat as well as European PMIs as well as confidence indicators from Europe including the German IFO index. Then there is what is happening in the bond markets to yields on 10 year bonds as well as what is happening to bond auctions around the world. Plus there are speeches by various policymakers especially central bankers around the world, plus the monthly interest rate decisions and statements and Draghi, Bernanke and King's press conferences after the decisions. The average academic economist in a British university knows little or nothing about this and hence is not a potential contributor to Bloomberg News or Radio 4's the Today programme, PM or the World at One, Radio5 Live, the BBC New Channel, or BBC2's Newsnight. By the way no need to be scared of Jeremy Paxman I found him extremely pleasant and fair.[5] I have even become an expert on France.[6] Economists need to join the club especially if they disagree, and engage in the public debate.[7] If you don't others will and have who know less.

A pretty good indicator of quality is the number of citations in the Web of Science as well as in Google Scholar where a paper cited a thousand times is a big deal.[8] According to RePec the ten

[5] Apparently viewing figures are much higher when Paxman is the host

[6] http://www.bloomberg.com/video/92043651/

[7] For example, Tory MP Grant Shapps tweeted me today to ask 'so how long is it ok to go on borrowing £1 for every £4 spent?' My answer was 'Depends what you spend it on. Think about a large firm, presumably you think it ok for them to borrow to invest in a shipyard?' I wonder what other economists think? I don't know as nobody engages.

[8] For example, Alan Krueger, currently chair of the Council of Economic Advisers and Nobel Laureate Jim Heckman both have twelve papers with a thousand Google cites or over and Heckman has one paper on sample

most cited UK economists in order are as follows, with overall ranking among all 32000 economists in the database in parentheses.[9] It is notable that with the exception of Chris Pissarides, who just received a Nobel prize, all are basically empirical - Besley does a mix of theory and empirics and was an external member of the MPC.

(19) Richard Blundell (UCL)
(39) Hashem Pesaran (Cambridge)
(56) Steve Nickell (Oxford)
(61) Steve Bond (Oxford)
(64) Andrew Oswald (Warwick)
(68) Tony Venables (LSE)
(99) Tim Besley (LSE)
(124) Mark P. Taylor (Warwick)
(131) Chris Pissarides (LSE)
(144) John Van Reenen (LSE)

Notably the UK only has seven of the hundred most highly cited economists in the world, according to this measure.

There is little engagement in the newspapers where few write academics op-eds. Even fewer are prepared to go on TV and radio. I get to debate with the same old faces from the City of London; to this point the one major exception has been the fine transport economist David Newberry from Cambridge. In the US there is a long list of academics who write columns and appear on TV. The best known is Paul Krugman but also Bad DeLong, Barry Eichengreen and several of my Dartmouth colleagues including Doug Irwin and Matt Slaughter. There are also a lot of academics turned policy makers including Larry Summers, Robert Reich, Marty Feldstein and many others. In part this is because there are a number of jobs for academic economists, including on the panel of economic advisors to the President, which has had a list of economic luminaries as chairman (Duesenberry, Ackley, Greenspan, Okun, Lazear, Romer, Bernanke, Mankiw, Hubbard to name a few) as well as chief economist at the Labor Department (e.g. Holzer, Montgomery, Katz, Krueger, Lynch and Stevenson) and Abraham at the Bureau of Labor Statistics.[10] These are appointments that academics are given sabbatical leave to do from their home institutions for one year, as at the DOL, or two or three, as in the case of the Council. There is a tradition in both the US and the UK to take sabbatical leave to become members of the interest rate setting committee at the Federal reserve e.g. Mishkin (Columbia), Krosner (Chicago) and Blinder (Princeton) and at the Bank of England e.g. Nickell (Oxford) and Besley (LSE). Ben Bernanke, Charlie Bean, Mervyn King and Stan Fisher resigned their academic jobs to take permanent appointments at central banks. A number of European academics have also become involved in the media, including Charles Wyplotz and Paul De Grauwe and some have

selection bias with 14700 cites (Heckman, James (1979), "Sample selection bias as a specification error with an application to the estimation of labor supply functions", in James Smith (Ed.) Female labor supply, (Princeton: Princeton University Press).

[9] http://ideas.repec.org/top/top.person.nbcites.html#pbl22

[10] http://www.whitehouse.gov/administration/eop/cea/about/Former-Members

taken up policy positions including Coen Teulings in the Netherlands, Wolfgang Franz and Christoph Schmidt in Germany and Bertil Holmlund and Lars Calmfors in Sweden.

There are important exceptions of course in the UK including Andrew Oswald and Marcus Miller at Warwick; David Bell from Stirling, Simon Wren-Lewis from Oxford, John Van Reenen from the LSE and Jonathan Portes from NIESR but the list gets pretty thin after that. These characters variously appear on TV and radio, write blogs and opeds and some even tweet! Retired academics including Lords Skidelsky, Desai and Layard are especially active. It has to be said that the turnout to write complaining letters to various newspapers has been somewhat better. Analogously very few academic economists seem to have joined twitter that appears to have largely replaced blogging. Paul Krugman, for example, has over three quarters of a million followers.

So why the great fear of being engaged? Lack of self-confidence is one explanation. But economists spend their lives standing up in front of students explaining complicated arguments so that doesn't wash. I suspect the big concern is that they will be forced to move outside their comfort zone and be asked questions about something else. That is a big mistake as firstly, they don't have to be drawn but secondly, and more importantly, even though they know little they may well know more than anyone else. If the professionals are not prepared to contribute then the amateurs, including the politicians get to take over.

This paper is about the need for engagement and involvement of the economics profession in the problems of our day, principally on the macro-economy, because that is where the most important problems are. We have been hit by a once in a hundred years recession and the economics profession has largely been quiet. Why did so few people see this catastrophe coming and what should we do about it? In what follows I am going to discuss the policy mistakes and look for help. What should we do about rising unemployment? What is the best way to get youth unemployment down? How do we get the economy back to growth? Is there evidence that supports the contention that fiscal contractions are expansionary?

Economists didn't deliver

Where were economists in our hour of greatest need? Where were you? Asking a similar question, Paul Krugman says he is ashamed of economists and concluded as follows in his address at the University of Linz on February 27th 2012.[11]

> "I blame economists, who were incoherent in our hour of need. Far from contributing useful guidance, many members of my profession threw up dust, fostered confusion, and actually degraded the quality of the discussion. And this mattered. The political scientist Henry Farrell has carefully studied policy responses in the crisis, and has found that the near-consensus of economists that the banks must be rescued, and the semi-consensus in favor of stimulus in the initial months (mainly because the freshwater economists were caught by surprise, and took time to mobilize) was crucial in driving initial policy. The

[11] http://krugman.blogs.nytimes.com/2012/03/05/economics-in-the-crisis/?pagewanted=all

> profession's descent into uninformed quarreling undid all that, and left us where we are today.
>
> And this is a terrible thing for those who want to think of economics as useful. This kind of situation is what we're here for. In normal times, when things are going pretty well, the world can function reasonably well without professional economic advice. It's in times of crisis, when practical experience suddenly proves useless and events are beyond anyone's normal experience, that we need professors with their models to light the path forward. And when the moment came, we failed." Wow!

The economics profession missed the big one. Largely I suspect also because they had their eyes elsewhere and had become interested in theoretical niceties and had failed to follow Larry Summers' (1991) wonderful piece of advice about the need to confront theory with the data.[12] He called it the 'scientific illusion' in empirical macroeconomics.

> "formal empirical work which…'tries to take models seriously econometrically' has had almost no influence on serious thinking about substantive as opposed to methodological questions. Instead the *only* empirical research that has influenced thinking about substantive questions has been based on methodological principles directly opposed to those that have become fashionable in recent years. Successful empirical research has been characterized by attempts to gauge the strengths of associations rather than to estimate structural parameters, verbal characterizations of how causal relations might operate rather than explicit mathematical models, and the skilful use of carefully chosen natural experiments rather than sophisticated statistical techniques to achieve identification." (p.129).

And later.

> "Good empirical evidence tells its story regardless of the precise way in which it is analyzed. In large part it is its simplicity that makes it persuasive. Physicists do not compete to find more elaborate ways to observe falling apples. Instead they have made progress because theory has sought inspiration from a wide range of empirical phenomena. Macroeconomics could progress in the same way. But progress is unlikely as long as macroeconomists require the armor of a stochastic pseudo-world before doing battle with evidence from the real one." (p.146)

The profession had become complacent, none more so than Bob Lucas, winner of the 1995 Nobel Prize in economics in his 2003 Presidential address to the American Economic Association who seems to have called it wrongly.[13]

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[12] Lawrence H. Summers, 'The Scientific Illusion in Empirical Macroeconomics,' The Scandinavian Journal of Economics, Vol. 93, No. 2, Proceedings of a Conference on New Approaches to Empirical Macroeconomics, June, 1991, pp. 129-148.

[13] R.E. Lucas, 'Macroeconomic Priorities,' The American Economic Review, March 2003, pp. 1-14.

"Macroeconomics was born as a distinct field in the 1940's, as a part of the intellectual response to the Great Depression. The term then referred to the body of knowledge and expertise that we hoped would prevent the recurrence of that economic disaster. My thesis in this lecture is macroeconomics in this original sense has succeeded: its central problem of depression prevention has been solved, for all practical purposes, and has in fact been solved for many decades".

In the summer of 2008, just before the crash of Lehmans, Olivier Blanchard, now chief economist at the IMF, published an NBER working paper entitled 'The state of macro is good', which made no mention of bubbles or any real world data.[14] In it he argued that 'macroeconomics is going through a period of great progress and excitement' outlining what a typical article in macro looks like. No mention here of trying to test against data from the real world: calibration is just making things up because the model doesn't actually fit the real world.

"A macroeconomic article today often follows strict, haiku-like, rules: It starts from a general equilibrium structure, in which individuals maximize the expected present value of utility, firms maximize their value, and markets clear. Then, it introduces a twist, be it an imperfection or the closing of a particular set of markets, and works out the general equilibrium implications. It then performs a numerical simulation, based on calibration, showing that the model performs well. It ends with a welfare assessment."

I have no idea what haiku-like rules are. I have been especially struck by the totally ludicrous claims made by Chari and Kehoe who seem to have entirely missed the plot.[15] If economics is not, what Harberger in 1993 called an 'observational discipline', it is nothing.[16]

“Over the last three decades, macroeconomic theory and the practice of macroeconomics by economists have changed — for the better. Macroeconomics is now firmly grounded in the principles of economic theory”

I would have hoped that macroeconomics would have been well grounded in the muddy waters of the data rather than being embroiled in arguments between the fresh water and saltwater kind of economics (Chicago and Minnesota vs Princeton and Harvard). Difficulties arise when a subject emphasizes theory over empirics. Theory is fine but we need to test it against data from the real world to see if it is actually true rather than just elegant. Nobel Laureate Bob Solow as ever had it right in his summary of where macroeconomics has ended up.[17]

[14] Olivier Blanchard, ‘The state of macro’, NBER WP14259, August 2008.

[15] V. V. Chari and P. Kehoe (2006), ‘Modern macroeconomics in practice: how theory is shaping policy’, Journal of Economic Perspectives, Fall, pp. 3–28.

[16] Arnold Harberger (1993), 'The search for relevance in economics,' American Economic Review Papers and Proceedings, 83, pp.1-16.

[17] Robert Solow (2008), Journal of Economic Perspectives, 22(1), Winter, pp. 243-249.

> “The other possible defence of modern macro is that, however special it may seem, it is justified empirically. This too strikes me as a delusion. In fact ‘modern macro’ has been notable for paying very little rigorous attention to data. I am left with the feeling that there is nothing in the empirical performance of these models that could come close to overcoming a modest scepticism. And more certainly, there is nothing to justify reliance on them for serious policy analysis”

The consequences of this lack of understanding of how the real world operates has led to western economies being unprepared for what was coming, especially because of their narrow focus on inflation. Of particular relevance are Paul De Grauwe's well know comments in the Financial Times on July 22nd, 2008.

> “There is a danger that the macro-economic models now in use in central banks operate like a Maginot line. They have been constructed in the past as part of the war against inflation. The central banks are prepared to fight the last war. But are they prepared to fight the new one against financial upheavals and recession? The macroeconomic models they have today certainly do not provide them with the right tools to be successful. They will have to use other intellectual constructs to succeed."

The workhouse models for monetary policy analysis by central banks over the last decade are largely based on the new-Keynesian Phillips curve literature. This class of real business cycle models incorporates some nominal rigidities, but is actually more in the tradition of Friedman, stressing the importance of inflation expectations. However, there is little role for financial intermediation, money supply growth, asset prices and changes in the structure of wage setting which inevitably limits their usefulness. These models have been a poor tool for monetary policy makers.

Robert Skidelsky in an article in the Washington Post October 14th, 2008 was spot on in his criticisms of these various models.

> "But what is in even shorter supply than credit is an economic theory to explain why this financial tsunami occurred, and what its consequences might be. Over the past 30 years, economists have devoted their intellectual energy to proving that such disasters cannot happen. The market system accurately prices all trades at each moment in time. Greed, ignorance, euphoria, panic, herd behaviour, predation, financial skulduggery and politics -- the forces that drive boom-bust cycles -- only exist off the balance sheet of their models. So mainstream theory has no explanation of why things have gone so horribly wrong".

Lord Skidelsky goes on to suggest that to understand how markets can generate their own hurricanes we need to return to John Maynard Keynes. Is Skidelsky right? What is the actual evidence? Was the financial crisis predictable? It is perfectly possible that as economists we had insufficient understanding of the importance of herd behaviour in all of this, in housing and money markets, and that economics is too short of work on such phenomena.[18] Above all, was there something we economists could reasonably be expected to have said and then done well before the crash? Why didn't we pay more attention to tail risks? The events of the last twelve months represent a challenge to economists. Does mainstream theory have an adequate explanation of why things have gone so badly wrong? It is not clear it does. It may well be time for a rethink.

Collapse, recovery, flatlining and revisions

I am particularly struck by how little engaged the economics profession has been on the causes and consequences of the Great Recession. Should we have spotted it coming? Given the profession mostly didn't spot it how much attempt has there been to address the failings in our economic models. Was it right to slash spending as the 20 letter writers to the Sunday Times in February 2010 wanted. Were the sixty economists who responded in a follow-up letter in the FT right? What has gone wrong? What policies should we be adopting right now? In the UK, should (Chancellor) Osborne change course, if so how? Does (Shadow Chancellor) Ed Balls have the fix in his five point plan? These are all questions that need addressing and, as far as I can tell, have not been.

It is certainly appropriate to take a look at the role of the Bank of England, including both the Governor and the MPC as well as why their forecasts have been so hopeless. Also the role of the Office of Budget Responsibility and its forecasts need to be examined. This is what I do in this section.

Chart 1 shows the increase in the overall UK unemployment rate and the youth unemployment rate since 2005. Unemployment jumped from 4% in July 2005 to 8.3% today and from 1,423,000 to 2.67 million. One in five youngsters age 18-24 are unemployed. Youth unemployment dropped sharply after the Labour government introduced the Future of Jobs Fund and the Educational Maintenance Allowance targeted on reducing youth joblessness. Youth unemployment started rising again once the incoming coalition government abolished these programmes, which were working. In the US the unemployment rate increased to 10% but is now falling with the latest estimate for April 2012 at 8.1%. Youth unemployment is at 16% but the duration of unemployment has risen.

Table 1 shows the loss in output in the UK since 2008, measured by changes in quarterly GDP measured as a quarter on quarter change. I split the table into four distinct parts:
1) Great Moderation (Q12006-Q12008)
2) Great Recession (Q22008-Q22009)
3) Darling Recovery (Q32009-Q32010)
4) Osborne Collapse (Q42010-Q12012)

[18] For more on human imitation and herd behaviour see Andrew Oswald's CEP/LSE November 2011 lecture entitled 'Herd Behaviour and Keeping up with the Joneses' at http://andrewoswald.com/presentations.html. A full set of references are available here http://andrewoswald.com/docs/revHandoutOswaldHerdBehaviourLiterature.pdf. See also Blanchflower David G.; Oswald Andrew J.; Van Landeghem Bert, Title: Imitative obesity and relative utility' Journal of the European Economic Association, Volume: 7, pp. 528-538, April 2009

GDP growth using the most recent estimates available in each of the four groups was +6.2%; -7.4%; +3.1% and -0.3% respectively. The Great Moderation covers the final eight quarters of the sixty two successive quarters of positive GDP growth that started in Q21992. The second period is the Great Recession that saw a collapse in output unprecedented since the 1930s. The third period that I call the Darling Recovery achieved growth of +3.1% through a combination of fiscal and monetary stimulus. The final group is what I have termed the Osborne Collapse, which dates from the fourth quarter of 2010. It seems reasonable to use this as a starting point given that it takes time for policies to have an effect and the coalition was not formed until May 2010. Over the six quarters since the end of 2010 growth has declined by 0.2%.[19]

The first column includes the preliminary estimate, which is reported, usually three weeks or so after the quarter is completed and covers only about 40 per cent of the economic activity which will be included in the more mature estimates published around 12 months later. For example the first estimate for Q12012 GDP of -0.2% was reported on April 25th 2012. These numbers then enter into a revision cycle and are subject to revision for years ahead. Currently the ONS provides a revision triangle for these data as far back as 1992Q1 which last had a revision in September 2008.[20] The average size of revisions since 1993Q1 is +0.1% and since 2006Q1 is -0.1%. The reason for the upward revision is principally the change in the deflator from the RPI to the CPI. This did have an upward impact on GDP growth on average but it would be wrong, without knowing details of any proposed methodological changes and their impact, to assume that such revisions will be repeated.[21] The large downward revision to 2008 growth rates at Blue Book 2011 I understand from the ONS was due to 'new data from various sources, including company profits from HM Revenue and Customs, being taken on in the balancing process'

The definitive source on Data revisions is a paper by Brown et al.[22] They conclude that:

> "Although there is some evidence of historical upward bias in revisions, its extent and direction have not been stable or predictable. Further, any such bias appears to have been smaller since the mid-1990s, and insignificantly different from zero. Revisions are not sufficiently large, regular or predictable to be able to support any procedure of incorporating bias adjustments into early estimates."

Despite this there has been some controversy over the quality of the data as some commentators claim to 'know' that these numbers will be revised upwards.[23] The best one can probably say

[19] Over the period Q42009-Q42010 Spain grew by 0%, whereas from Q42011-Q12012 Spain grew by +0.2% or more than the UK despite having a 24% unemployment rate.

[20] http://www.statistics.gov.uk/statbase/Product.asp?vlnk=13560

[21] 'Impact of changes in the National Accounts and Economic Commentary for 2011 quarter 2', Peter Patterson, Pete Lee and Malindi Myers Office for National Statistics, 2011

[22] 'Understanding the quality of early estimates of Gross Domestic Product' Gary Brown, Tullio Buccellato, Graeme Chamberlin, Sumit Dey-Chowdhury and Robin Youll ONS 2010

[23] http://www.newstatesman.com/politics/politics/2012/05/recession-deniers-it%E2%80%99s-time-face-grim-reality-uk-plc

currently is that any revision is likely to be small. But that is not to say that past revisions have been small as is clear from columns 2 and 3 of the Table. Column 2 of the table reports the latest estimate while column 3 is the extent and the direction of the revisions

The revisions really do matter and this is something that academics really do need to pay attention to. The main findings in relation to the revisions are as follows

1. Growth in 2007 was revised strongly upwards; by 0.4% in each of the first three quarters. If I had known how strong growth was, in all likelihood I would have voted on the Monetary Policy Committee for further rate increases, particularly in the early months of 2007. The extent of the slowing at the end of 2007 that I observed now looks even sharper than it did, so it was probably right to start voting for rate cuts at the end of 2007.

2. Revisions moved the start of the recession earlier than it first appeared – from Q32008 to Q22008. The preliminary estimate for Q22008 was 0.2% that the MPC received in April 2008. In September 2011 that number was revised to -1.3% suggesting that the recession had started but was not apparent from the official data. Tim Besley even voted for rate increase from 5% to 5.25% in both July and August 2008, but surely would not have done so if he had known the economy had already entered recession. The preliminary estimate of -0.5% really put the cat among the pigeons at the Bank of England at the end of September 2008, but more on that below. Interest rates were cut by 50bp on October but panic would have really set in if we had known the latest number of -2.0%. Given that Q12008 stands at zero at the time of writing it will only take a minor revision to move the start of the recession even earlier.

3. The biggest news is what happened in 2008 where the revisions make it clear that the recession was much deeper than first thought; Q1 was revised down from 0.4 per cent to 0 per cent; Q2 from 0.2 per cent to -1.3 per cent; Q3 from -0.5 per cent to -2 per cent; and Q4 from -1.5 per cent to -2.3 per cent. In short, aggregate initial estimates of -1.4 per cent were revised down to -5.6 per cent. Thank goodness we threw the kitchen sink at the problem, cutting rates from 5% in October to 2% in December.

4. The first two quarters of 2009 are still negative but revisions made the recession shorter. Growth achieved by Darling recovery in his five quarter-long upswing was +3.1% revised up from +1.8%. The stimulus worked.

5. Then there is the Osborne collapse when over a six quarter period the economy shrank by 0.2%.

The scale of the drop in output is much greater than was true in the United States. This is shown in Table 2, which presents current estimates on the scale of the shock across countries between 2008Q1 and 2009Q2.[24] The US saw a GDP drop of 5.2% compared with the drop in the UK of 7.2%. Germany, Italy, Portugal, Spain and France all had smaller drops in output than the UK in part because of the size of the UK financial sector (-5.6%; -3.6%; -3.8%; -4.0% and -6.7%

[24] The US, the UK and the Euro area all went into recession, in terms of a GDP drop in 2008Q2. The NBER dating group called the start of the recession as December 2007, based on the rise in unemployment.

respectively). The UK drop was sixth largest on the list, only smaller than in Estonia (-19.3%), Ireland (-11.7%); Finland (-10.6%); Iceland (-9.2%) and Denmark (-8.2%).

The extent of the recovery, as documented in column 2 of the table has been patchy across countries. In contrast a number of countries have now restored the lost output – the list includes Austria, Belgium, Canada, Germany, Mexico, Sweden and the United States. Greece and Ireland are in especially bad shape being 9.4% and 12.1% respectively below output at the start of the recession. The UK has not even restored half of the drop in output after 48 months which means that it will be much longer lasting than the Great depression, which as Chart 2 makes clear, was over, also after 48 months.

The crisis was foreseeable

It really mattered that most macroeconomists had their eyes focused on inflation and their DSGE models and failed to notice what was happening around them. This was especially true at the Bank of England, which has been run as a fiefdom by Mervyn King.[25] In my view he made the Bank the bank for monetary economics with little interest in regulation, market intelligence, talking to bankers and hedge funds or the data for that matter. That looks to have been a major mistake for which he must be held responsible. The MPC failed to spot the greatest recession in all our lifetimes until they fell over it. *Monetary policy failed*. Nobody though seems to want to take responsibility.

In an article in the Financial Times on May 4th 2012 Chris Giles argued that as soon as King became governor in 2003, all that mattered was monetary economics and regulation was irrelevant. Financial stability mattered primarily just for monetary policy.

> "the staff became aware the new governor had big plans to remould the BoE [Bank of England] in his own academic image. Already shorn of banking supervision and government debt management in the post-1997 changes, Sir Mervyn wanted to create a modern monetary authority concentrating on monthly decisions on interest rates. Although one of the BoE's two core purposes was "to ensure financial stability", it seems he neither enjoyed nor fully understood the influence the BoE still had in calming financial excess by use of its powerful voice. Work in the financial stability division did not excite him and he told colleagues to "operationalise" it, by which he meant simply writing and publishing two financial stability reports every year. Sir Mervyn demonstrated the low status he attached to such reports by not presenting them himself, unlike the inflation report, which he nurtured and presented as chief economist….Staff found presenting financial stability issues in front of the new governor frightening because of his apparent disdain for their work."

In a lecture on Radio 4's the Today programme King blamed Gordon Brown, the banks and the Financial Services Authority for all that happened.[26] No mea culpa here.

[25] http://www.newstatesman.com/economy/2009/09/mpc-bank-recession-king-rates and http://www.newstatesman.com/politics/2012/04/mervyn-king-tyrant-who-will-succeed-him-bank

[26] http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech567.pdf

> "In August 2007 came the moment when financial markets began to realise that the emperor had no clothes. The announcement by the French bank BNP Paribas that it would suspend repayments from two of its investment funds triggered a loss of confidence and a freezing of some capital markets. A month later, the crisis claimed its first victim when Northern Rock failed. In the months that followed, there was a steady procession of banking failures culminating in the collapse of the American bank Lehman Brothers in September 2008. Financial waters, already extremely chilly, then froze solid. Banks found it almost impossible to finance themselves because no-one knew which banks were safe and which weren't."

And later

> "It's vital that we learn from the crisis. A good place to start is to ask, as the Queen famously did, 'Why did no-one see this coming?' The answer is extremely simple: no-one believed it could happen. Recessions were supposed to follow booms and high inflation, not periods of steady and sustainable growth with low inflation. There seemed to be no reason to expect the worst recession since the 1930s."

As a result, King claimed the Bank of England really did spot the crisis but it was everyone else's fault. His mistake was not shouting loudly enough. No misjudgment there. No blame falls his way.

> "That isn't to say we were blind to what was going on. For several years, central banks, including the Bank of England, had warned that financial markets were underestimating risks. So why, you might ask, did the Bank of England not do more to prevent the disaster? We should have. But the power to regulate banks had been taken away from us in 1997. Our power was limited to that of publishing reports and preaching sermons. And we did preach sermons about the risks. But we didn't imagine the scale of the disaster that would occur when the risks crystallised. With the benefit of hindsight, we should have shouted from the rooftops that a system had been built in which banks were too important to fail, that banks had grown too quickly and borrowed too much, and that so-called 'light-touch' regulation hadn't prevented any of this. And in the crisis, we tried, but should have tried harder, to persuade everyone of the need to recapitalise the banks sooner and by more. We should have preached that the lessons of history were being forgotten – because banking crises have happened before.

We pay the governor a large salary to have some foresight. No mea culpa here, which should surprise nobody. Sadly these claims don't seem to stand up to scrutiny.

Blaming Gordon Brown, the FSA and the banks simply doesn't wash. There actually is quite a lot of evidence suggesting that King personally missed what was going on. I do recall sitting at the same table in front of the Treasury Select Committee in March 2008 when these issues were raised. I went back to the transcripts and this is what I found.[27] Labour MP Andy Love asked him if we needed more regulation to which King replied "A brief answer would be do not have knee-jerk reactions but think very, very deeply about the causes of this crisis and whether levels of bank capital and the sort of financial system that generated this crisis does not require some action." No 'we need more regulation there' from the rooftops or any place else. Obviously nothing was learnt from the failure of Northern Rock.

I was also at the same hearing and was asked about the biggest risk to the UK economy.

> "The difference between me and most of the members of the Committee in terms of the way the Inflation Report was written was my concern with risks to the downside, especially coming from the credit market. I guess from your earlier question, having seen what has happened in the US is that activity will drop dramatically and that would be something I do not want to see. My concern is that it is appropriate to take out some insurance and get ahead of the curve in the sense that the arguments made on the upside were that, but it seems to me those arguments apply on the downside too, so my concern would be one should make sure one is ahead of the curve so that later one is not in a position where something horrible happens, I do not want that to occur. My risks are to the downside and I have concerns that something horrible might come and I do not want that to happen."
> Evidence to the Treasury Select Committee: David Blanchflower, 26th March, 2008.

It isn't as if King and other members of the MPC weren't warned by a member of their own committee six days before the UK economy actually did enter recession on April 1st 2008.

At the March 26th 2008 Treasury Committee hearing Love also asked King whether he was concerned that as the US was in recession it might spread to the UK. "For us, far more important than the United States in terms of the impact on demand in the UK is the impact on the euro area because they have a weight three times larger than the United States in our trade-weighted index, so what happens in the euro area is much more important to us directly than the US economy." I heard him claim the UK had decoupled from the US many times. It had not of course.

A month later I gave a speech for the David Hume Institute at the Royal Society of Edinburgh where I warned that I was "particularly concerned that the UK exhibits broad similarities to the US experience". I set out what I called four phases of the downturn in the United States based on data I had available up to 23rd April 2008. The data are available also as an appendix to the paper.[28]

Phase 1 (January 2006-April 2007). The housing market starts to slow from its peak around January 2006. Negative monthly growth rates in house prices started to appear from the Autumn of 2006.

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[27] http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/453i/8032603.htm

[28] http://www.bankofengland.co.uk/publications/Documents/speeches/2008/speech346.pdf

Phase 2 (May 2007-August 2007). Substantial monthly falls in house prices and housing market activity including starts and permits to build were observed from late Spring/early Summer of 2007. Consumer confidence measures alongside qualitative labour market indicators, such as the proportion of people saying jobs are plentiful, started to drop precipitously from around September 2007.

Phase 3 (September 2007-December 2007). Average hourly earnings growth started to slow from September 2007 as does real consumption. The growth in private non-farm payrolls starts to slow. House price and activity declines speed up.

Phase 4 (January 2008-). By approximately December 2007 the housing market problems had now spilled over into real activity. The US seemed to have moved into recession around the start of 2008. There have been big falls in house prices. In March 2008 housing starts were at a seventeen year low. Foreclosure filings jumped 57% in March compared with the same month of 2007. One out of every 139 Nevada households received a foreclosure filing last month. California was second with a rate of one in every 204 homes with Florida third with a rate of one in every 282 being hit with a foreclosure filing. Mortgage application volume fell 14.2% during the week ending April 18, according to the Mortgage Bankers Association's weekly application survey. Refinance volumes fell 20.2% on the week. Nominal retail sales and real personal disposable income had both fallen sharply since the start of the year. Real annual GDP growth in 2007Q4 was down to +0.1%, from 1.2% in 2007Q3. Spending on big-ticket items in the US is tumbling. Labour market data released for the United States, for March 2008, showed the biggest drop in payrolls in five years, while applications for unemployment benefits are on the increase. Declines in employment were concentrated in manufacturing, construction and financial activities

In my speech I presented equivalent supporting data for the UK suggesting there were a number of strong similarities with the United States: the big difference is that in the UK the housing market was booming in 2006 and most of 2007.

Phase 1 (August 2007-October 2007). House prices start to slow in 2007Q2 and 2007Q3. Housing activity measures also slow from around October 2007.

Phase 2 (November 2007-January 2008). Consumer confidence measures started slowing sharply also from around October 2007. The qualitative labour market measures such as the REC Demand for Staff index also start slowing from around

Phase 3 (February 2008-?). In early 2008 the Halifax index and the RICS survey both suggest that house prices falls have started to accelerate. The Council of Mortgage Lenders (CML) announced that mortgage lending in March was down 17% on the year. Loan approvals were down, and the RICS ratio of sales to stocks was down from .38 in September 2007 to .25 in March 2008. Bradford and Bingley, Britain's biggest buy-to-let lender, has recently reported that some borrowers were finding it hard to repay their loans, so mortgage arrears are growing, reminiscent of what has been happening in the United States. The latest figures showed that the number of people whose homes were repossessed in 2007 went up by 21%. The CML said

27,100 homes, the highest figure since 1999, were taken over by lenders after people fell behind with repayments. According to data published by the British Bankers' Association the number of mortgages granted to homebuyers dropped last month by forty seven percent per cent below the same month last year to its lowest level in more than a decade. Some 35,417 mortgages were approved for home purchase in March compared with, 43,147 in February, a drop of 18%.

Hourly earnings growth was sluggish - both the AEI and LFS measures were slowing. Total hours and average hours started to fall in early 2008. Claimant count numbers for February 2008 were revised up from a small decline to an increase. There was a growth in the number of part-timers who say they have had to take a full-time job because they couldn't find a part-time job - up 37,000 in March alone.

Even though the number of unemployed had fallen, the duration of unemployment appears to be rising, which means that the outflow rate from unemployment had fallen. The numbers unemployed over 6 months in March 2008 was up 22,000 while the numbers unemployed for less than 6 months was down 47,000. As in the United States, I noted that recent declines in employment in the UK are concentrated in manufacturing, construction and financial activities.

Phase 4 was 'coming'. More bad news was on the way I argued. This is what I said.

> I think it is very plausible that falling house prices will lead to a sharp drop in consumer spending growth. Developments in the UK are starting to look eerily similar to those in the US six months or so ago. There has been no decoupling of the two economies: contagion is in the air. The US sneezed and the UK is rapidly catching its cold... Generally, forecasters have tended to under-predict the depth and duration of cyclical slowdowns."

Chart 3 provides some evidence that should have been hard to ignore. It plots the Halifax house price to earnings ratios that took a big drop in May 2012 from 4.42 to 4.33 as house prices fell 2.4% on the month.[29] The US housing market had started to collapse in 2006[30] which should have set alarm bells ringing given that the 1929 Great Crash started in the Florida housing market. UK average house price to earnings ratios had risen to unsustainably high levels. From 1983-2004 they averaged 3.4 but by July 2007 had reached 5.81. When King was interviewed in March 2008 the ratio had fallen to 5.44 and house prices were 5% below their peak nine months earlier.

That should have been a wake-up call but not for King and the other members of the MPC who even by the beginning of September 2008, a week before the collapse of Lehmans, had not spotted the big one and did not vote for rate cuts. Note that in the minutes of the September 2008 MPC meeting there is even a large section that argued for a rise in Bank rate.

[29] http://www.lloydsbankinggroup.com/media1/economic_insight/halifax_house_price_index_page.asp

[30] D. G. Blanchflower, 'Inflation, Expectations and Monetary Policy,' Bank of England Quarterly Bulletin, pp 229-237, Volume 48 No. 2, Q2 2008. Speech given in Edinburgh, March 29th 2008.

> "A case could be made for an increase in Bank Rate. There still remained a significant risk to inflation expectations from the expected short-term rise in CPI inflation. The recent fall in sterling, if sustained, might postpone the point at which inflation started to fall back sharply towards the target. High import price inflation and sterling's depreciation could be symptomatic of a weakening of confidence in the Committee's determination to return inflation to the target. An increase in Bank Rate now would emphasise the MPC's commitment to price stability and might result in an appreciation of sterling, relieving some of the upward pressure on import prices."

I ask you.

House price to earnings ratios are only held up at these currently historically high levels by the very low interest rates, and if they were to rise this would have downward and likely large impact on prices which certainly look set to fall further. To get back to long run averages would imply drops of at least 15% and probably more given likely overshooting.

I also recall Governor King being questioned in September 2008 at another TSC session after the August 2008 Inflation Report that failed to spot the recession coming.[31] Mr Love again asked 'On unemployment there have been some suggestions…that it may go up faster than the projections in the Inflation Report. Is that a worry to you? King's response was "*I do not think we really know what will happen to unemployment. At least, the Almighty has not vouchsafed to me the path of unemployment data over the next year*." (my italics). Unemployment had started rising in March of that year and would continue to do so for many months ahead and by that time and the Bank of England's agents scores on the labour market, had fallen off a cliff.[32] This is shown in Chart 4 which plots the Bank of England's Agents' scores for the state of the economy.

This is what I termed 'the economics of walking about' in a speech in 2007.[33] It follows on from a long tradition in Labour Economics going back to the writings of the Webbs in the UK and the early American labour economists Paul Douglas; John Dunlop; Clark Kerr; Richard Lester; Lloyd Reynolds; Sumner Slichter and Gregg Lewis. Clark Kerr encapsulated the spirit of these American labour economists when he said "Labour Economics will contribute more by helping to make a sense of reality than by building more castles in the air" (Kerr, 1988, p.33). At the time I very much felt I should give the MPC a dose of reality. The Bank's twelve Agents and their staff across the country report on their sentiment. The chart makes it clear that by the fall of 2008 employment intentions were spiraling downwards, both in manufacturing and services. These surveys were entirely consistent with other surveys of business and consumer confidence. Chart five reports surveys of four business groups – industry, services, retail and construction,

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31 http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/1033/8091107.htm

32 http://www.bankofengland.co.uk/publications/Pages/agentssummary/default.aspx

33 David G. Blanchflower, 'Recent developments in the UK economy: the economics of walking about', Bank of England Quarterly Bulletin, pp. 317-329, 2007Q2, 47(2).

plus an interview among consumers. All of these surveys had plummeted and were saying the same thing – the UK was headed to recession.

Finally, in contrast to the Governor of the Bank of England it appears that the men and women who ride on the Clapham omnibus did have some idea of what was going to happen to unemployment. They did walk about. Chart 6 reports the results from the EU survey of the responses to the question what did the respondent think was going to happen to unemployment over the next six months. It is reported as a balance, that started to rise sharply from the end of 2007 and by July 2008 had reached its highest level since March 1993 when the unemployment rate was 10.6%.

King and the other members of the MPC simply didn't get it and they should have. But it was to get worse because even after they missed the start of the recession they seemed unable to contemplate its scale or duration. We now turn to looking at the forecasts of growth by both the MPC and the OBR. For simplicity I ignore the inflation forecasts.

Growth forecasts

It is appropriate to look at the growth forecasts before and after the recession to see why the recession was missed and whether those errors have been fixed. There seems to be little evidence to support such a proposition.

a) Monetary Policy Committee

Chart 6 contains the famous MPC fan charts for growth. Part A is the forecast from the August 2008 Inflation Report that I initially signed up to but then realised was far too optimistic. The Inflation Report itself doesn't contain the word recession. The central projection is that there will not even be a single quarter of negative growth, output will be restored quickly and trend growth will be restored by 2010. Plus data from the past – in what is called the *backcast* - will all be revised upwards, because the dark green fan is mostly above the dark line which is the latest ONS estimate at the time of the forecast. A month later Lehmans had failed and three months later interest rates had been cut to 2% and eventually to 0.5%. In March 2009 the MPC would then embark on a programme of quantitative easing because the economy was in such bad shape. Plus there were loans to RBS and Lloyds that the external members of the MPC were never told about.

Part B is from May 2010, just before the coalition was formed and it painted a pretty rosy picture. Recovery was nicely underway and trend growth was still headed the UK's way, but not before 2011. The MPC did not expect data for any of 2008 to be revised down but did expect data for 2009 to be revised up. Recovery, of course was going to be V-shaped, what else could it be? Well actually W-shaped or even L-shaped looked increasingly likely if austerity was to hit.
Indeed the MPC projected that the level of GDP would be back to that at the start of the recession by the beginning of 2011. This can be seen in Panel C which plots the level of GDP based on the market interest rate of 0.5% essentially and £260 billion of QE. The recovery date for the recession is obtained by drawing a line over from the start. If we refer back to Chart 2 this means that the MPC were projecting that the recession would be over in 36 months, essentially copying the growth path in the 1930s but with a much more rapid exit. It never looked like that would happen and it didn't.

It didn't turn out so well for the MPC because, as we saw from Table 1, the GDP data for 2008 was heavily revised downwards from 6% to over 7%. Chart D reports the February 2012 forecast. Growth in 2011 was not 3% as predicted in both August 2008 and June 2010 but 0.8%. But never fear the recovery is expected to spring back to life as the GDP data is expected to be revised upwards and growth data for Q12012 was expected by the MPC to be positive, but wasn't. Oh dear, here they go again, growth of 5.5% annualised is inside the fan while a negative number is excluded. It looks awfully like the same mistake being repeated again and again. I have said on many occasions the MPC growth forecasts are aspiring to be hopeless.

The most recent chart available at the time of writing taken from the May 2012 Inflation report is presented in Part E and shows once again a highly bullish growth forecast. Astonishingly growth of 5.5% is inside the 90% confidence fan once again as early as 2013Q3 while zero or negative is outside it. Despite all the identified risks apparently from the euro area the committee decided that risks to inflation were balanced. On 22nd May 2012 the IMF said that "risks are large and tilted clearly to the downside."[34] More astonishing still is the fact that even with that bullish growth forecast inflation is below the 2% target at the two year forecast horizon. This implies the MPC should have loosened monetary policy further. This was a point made by the IMF a week later in its Article IV Consultation 2012 when it argued

> "Further monetary easing is required. Anemic nominal wage growth and broadly stable inflation expectations suggest underlying inflationary pressure is weak, providing space for greater monetary easing. That said, uncertainty about inflation dynamics and the strength of disinflationary pressure coming from the output gap imply risks that inflation could take longer-than-expected to return to target, with convergence being further delayed by additional monetary easing. Nonetheless, the cost of such a delay is likely to be low relative to the benefits of a more rapid closing of the output gap.

I have no explanation for why the MPC didn’t act and start a new round of quantitative easing other than sheer incompetence.

Why does the MPC continue to believe the recovery will be V-shaped when it hasn't been to this point? Is this a function of the models simply being mean reverting? That may have worked in the Great Moderation where a 25bp tweak up or down did the job. I for one find it hard to see where growth comes from under current policies so an L-shape looks to fit the data (chart 2).

b) Office of Budget Responsibility.

The MPC is not alone in being over-optimistic in its growth forecasts. Table 3 reports Office of Budget Responsibility forecasts at the time of the June 2010 austerity Budget that killed off consumer and business confidence and destroyed growth. It didn't help that (Prime Minister) Cameron, (Deputy Prime Minister) Clegg and (Chancellor) Osborne claimed the country was bankrupt when it wasn’t, or that it was like Greece, which is locked in monetary union. Greece by the way is ranked 100th on the World Bank's *Doing Business* rankings, while the UK is ranked

[34] http://www.hm-treasury.gov.uk/ukecon_imf_2012.htm

7th.[35] There was never any empirical foundation for an expansionary fiscal contraction which has turned out to be a *contractionary fiscal contraction*. The UK is now enjoying the weakest peacetime recovery in a century and is well behind the recoveries in other countries, including several Euro Area countries more directly impacted by the crisis, including Belgium, France and Germany.

The OBR forecast growth of 2.3%; 2.8% and 2.9% in 2011, 2012 and 2013 respectively in 2010, revised down in February 2012 to 0.8%; 0.8% and 2.0%. There has not been a resurgence as predicted in consumption or business investment, although the OBR continues to forecast it will happen even though it hasn't. The saving grace has been net trade but that seems set to worsen especially given the 5% appreciation of the pound against the Euro recently. Unemployment is higher and employment lower than predicted. It remains unclear why the OBR believes earnings are about to take off; they haven't and they won't, given the high levels of unemployment and the high fear of unemployment (see Chart 6).[36] Other forecasters are much less optimistic.[37] NIESR is forecasting zero growth in 2012 and 2% in 2013 for example. According to the Treasury in April 2012 the consensus forecast for growth in 2012 is 0.6% and 1.7% in 2013. Among City forecasters for 2012 Capital Economics and Standard Chartered are forecasting -0.5% while Goldman Sachs are at the top end forecasting growth of 1.2% driven principally by consumption which seems highly unlikely. Among the Non-City forecasts the lowest is NIESR at zero with Liverpool Macro the highest at +1.4%. Capital Economics expects growth of only 0.5% in 2013. For 2012 both groups average forecast of 0.6% and they both average 1.7% for 2013.

One other issue that warrants attention is the extent of the cuts that the government has undertaken. New data from the International Labor Organisation sheds light on the scale of the deficit reduction that has gone on in the UK. This is reported in Table 4 where the ILO has tried to create a comparable series across countries, which makes clear the extent to which the coalition has cut is deeper than other countries. More tightening than in the US, Spain, Ireland and Greece or anywhere else for that matter, in 2011-2012. The main driver is public investment which was down 2% on the previous year. No wonder growth has tanked. So the claims that cuts haven't taken place look wide of the mark. Plus, at the time of writing, May 2012, the vast majority of the cuts haven't happened yet. I am fearful what the effect on the economy will be if they are implemented as growth seems set to worsen and the government still seems set on that course. The results of the local elections in April 2012 where the coalition had big losses suggest that a rapidly developed plan B may be in the offing. More cuts as some on the political right want would likely be disastrous both in economic and political terms. There is little evidence to support the claims made by Liam Fox and others that slashing worker's rights would give a kick start to growth. Firing people generally increases rather than deceases unemployment.[38]

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[35] www.Doingbusiness.org

[36] See David Blanchflower (1991), 'Fear, unemployment and pay flexibility', Economic Journal, March, pp. 483-496 and David Blanchflower and Chris Shadforth (2009), 'Fear, unemployment and migration', The Economic Journal, 119 (535), February, pp. F136-F182.

[37] http://www.hm-treasury.gov.uk/d/201204forcomp.pdf

[38] http://www.independent.co.uk/news/business/comment/david-blanchflower/david-blanchflower-slashing-employment-regulation-would-do-nothing-to-boost-growth-7441395.html

Conclusion

The onset of the Great Recession and the absence of any recovery in the UK represents a major challenge to economics. Why did it happen? Where did we go wrong? What policies are best to help the economy rebalance away from financial services but to what? How can the models be made more realistic? How much of the macroeconomics we teach to our students has to be binned?

I am greatly concerned that the economics profession has had so little involvement in the major issues of the day. That has resulted, in my view in some of the worst economic policy errors in a generation. Economists need to focus on real policy questions rather than simply on publishing trivial technical extensions in academic journal. I suspect that will also mean a movement away from theoretical papers with no data to papers that involve empirical testing and the search for patterns in the data.

I have been very struck by the difference between what a City economist does on a daily basis and how little need they have to consult, or even read anything academic economists write. Academic economists for their part seem to me to have little knowledge of where the economy is and any interest in data revisions, qualitative surveys of even macro-forecasting. When I was at the Bank of England trying to work out whether the economy was collapsing and needed outside advice on what was going on in the economy but received little help. That needs to change and the profession needs to engage in the real world. We do need to know what went wrong with the macro-forecasts and why the macro models turned out to be so little help when they were needed most. The following advice from some of the most famous names in economics seems appropriate and may be helpful.[39]

> *'It is a good morning exercise for a research scientist to discard a pet hypothesis every day before breakfast. It keeps him young'.*[40] Konrad Lorenz.
>
> *'In the case of the labour market, our preoccupation with price-mediated market clearing as the natural equilibrium condition may be a serious error'.*[41] Robert Solow.
>
> *'The vision I would like to carry away from this lecture sees economics as fundamentally an observational principle'.*[42] Arnold Harberger 1993 Richard T. Ely lecture to the American Economic Association

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[39] These quotes were originally used as chapter headings in my joint 1994 MIT press book with Andrew Oswald, The Wage Curve. They seem even more relevant today.

[40] Konrad Lorenz (1996), On Aggression, New York, New York, Harcourt Brace Jovanovich

[41] Robert Solow (1986), 'Unemployment; getting the questions right', Economica, 53, S23-S34.
[42] Arnold Harberger (1993), 'The search for relevance in economics', American Economic Review proceedings and Papers, 81, pp.1-16.

'Inspiration is most likely to come through the stimulus provided by the patterns, puzzles and anomalies revealed by the systematic gathering of data, particulalrly when the prime need is to break our existing habits of thought.'[43] Ronald Coase, 1991 Nobel Prize lecture.

'Good empirical evidence tells its story regardless of the precise way it is analysed. In large part, it is its simplicity that is persuasive'.[44] Larry Summers (1991).

'A full model and complete microeconomic foundation to wage adjustment with the power of the auction-model may never be forthcoming. If that is so we may have to look for regularities'.[45] Charles Schultz, 1984 presidential address to the American Economic Association.

The move in behavioural economics to test people's behaviour rather than assuming they know what it is, is certainly to be welcomed. For the sake of the country academic economists need to become engaged in the policy debate. It really would help, of course, if Vice-Chancellors explicitly gave incentives, perhaps via pay increases or study grants, to encourage their faculty to become engaged in policy debates, on TV and radio and also in advising politicians and joining in national debates. It is not good enough to say you were working on something else.

The big worry going forward is what to do next? The MPC will clearly be concerned about the inflation risk and the slowing economy but the downside risk to activity looms large which suggests they will have to push the trigger again. George Osborne's fiscal austerity has been a disaster but what is the alternative. Doing too much in these circumstances is better than doing too little. We would have been in much better shape today if Mervyn King and the MPC had realised that in 2007 and 2008. Now is the time for economists to start speaking up. Become engaged. Think more about policy rather than focusing on minor twiddles. The British public is entitled to ask "where were you when we needed you?" Get busy.

[43] R.H. Coase (1992), 'The institutional structure of production', American Economic Review, 82, pp. 713-719.

[44] Larry Summers (1991), ibid

[45] L.C. Schultze (1985), 'Microeconomic efficiency and nominal wage stickiness', American Economic Review, 75, pp. 1-15.

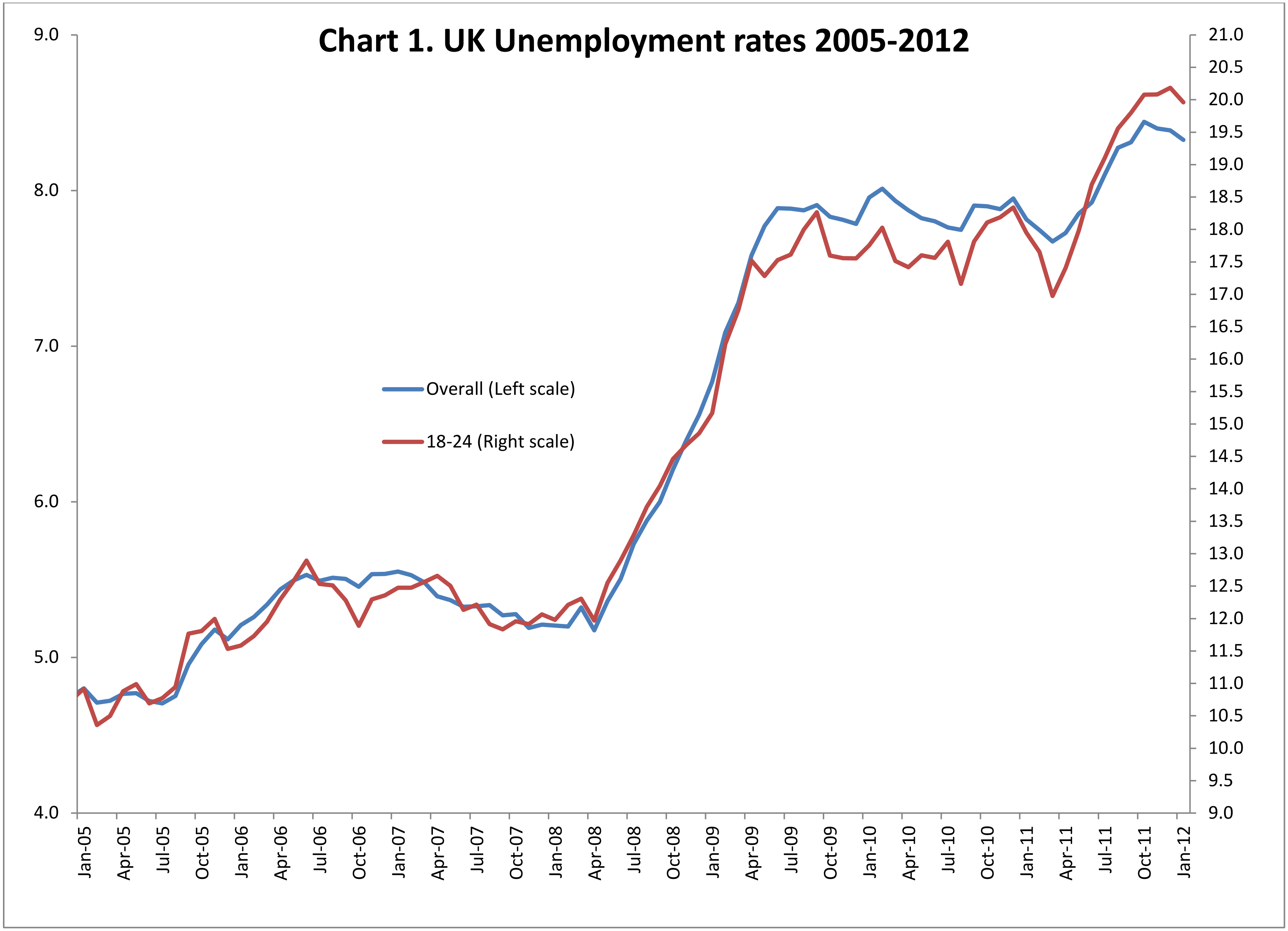
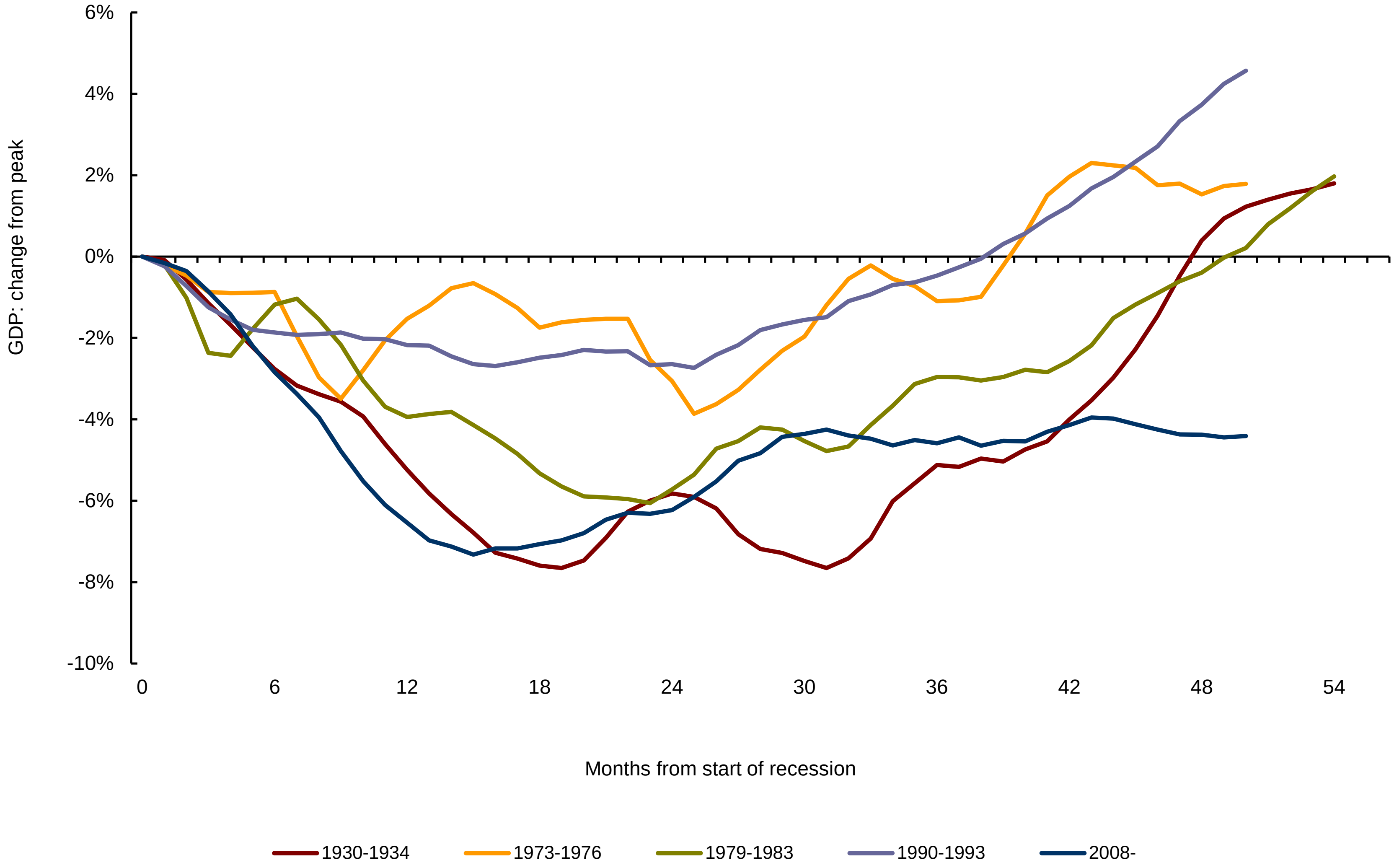


Chart 1. UK Unemployment rates 2005-2012
Overall (Left scale)
18-24 (Right scale)
9.0
8.0
7.0
6.0
5.0
4.0
21.0
20.5
20.0
19.5
19.0
18.5
18.0
17.5
17.0
16.5
16.0
15.5
15.0
14.5
14.0
13.5
13.0
12.5
12.0
11.5
11.0
10.5
10.0
9.5
9.0
Jan-05
Apr-05
Jul-05
Oct-05
Jan-06
Apr-06
Jul-06
Oct-06
Jan-07
Apr-07
Jul-07
Oct-07
Jan-08
Apr-08
Jul-08
Oct-08
Jan-09
Apr-09
Jul-09
Oct-09
Jan-10
Apr-10
Jul-10
Oct-10
Jan-11
Apr-11
Jul-11
Oct-11
Jan-12

Chart 2. GDP growth by Quarter in various recessions (Source: NIESR)



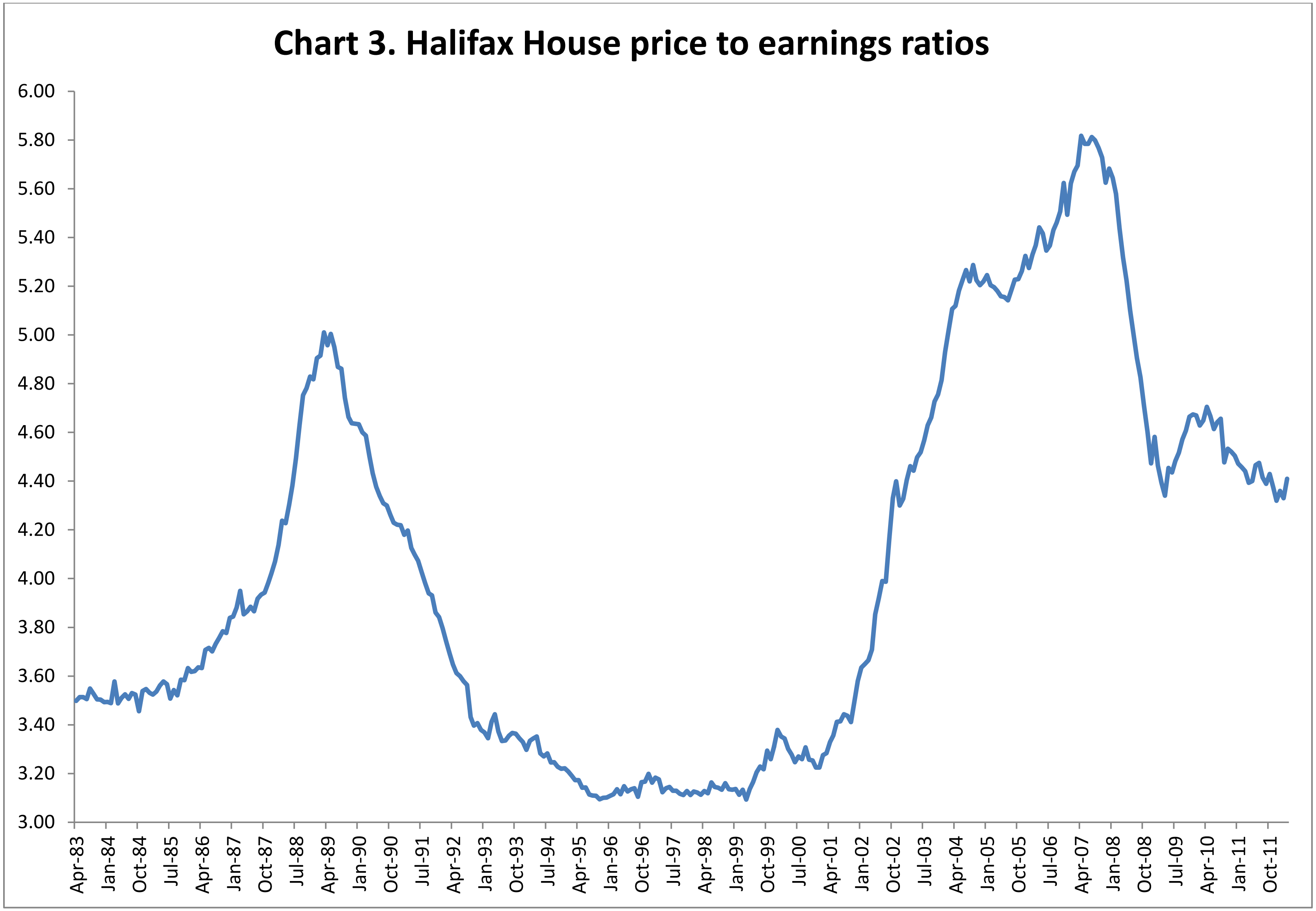


Chart 3. Halifax House price to earnings ratios
6.00
5.80
5.60
5.40
5.20
5.00
4.80
4.60
4.40
4.20
4.00
3.80
3.60
3.40
3.20
3.00
Apr-83
Jan-84
Oct-84
Jul-85
Apr-86
Jan-87
Oct-87
Jul-88
Apr-89
Jan-90
Oct-90
Jul-91
Apr-92
Jan-93
Oct-93
Jul-94
Apr-95
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Jul-00
Apr-01
Jan-02
Oct-02
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Apr-10
Jan-11
Oct-11

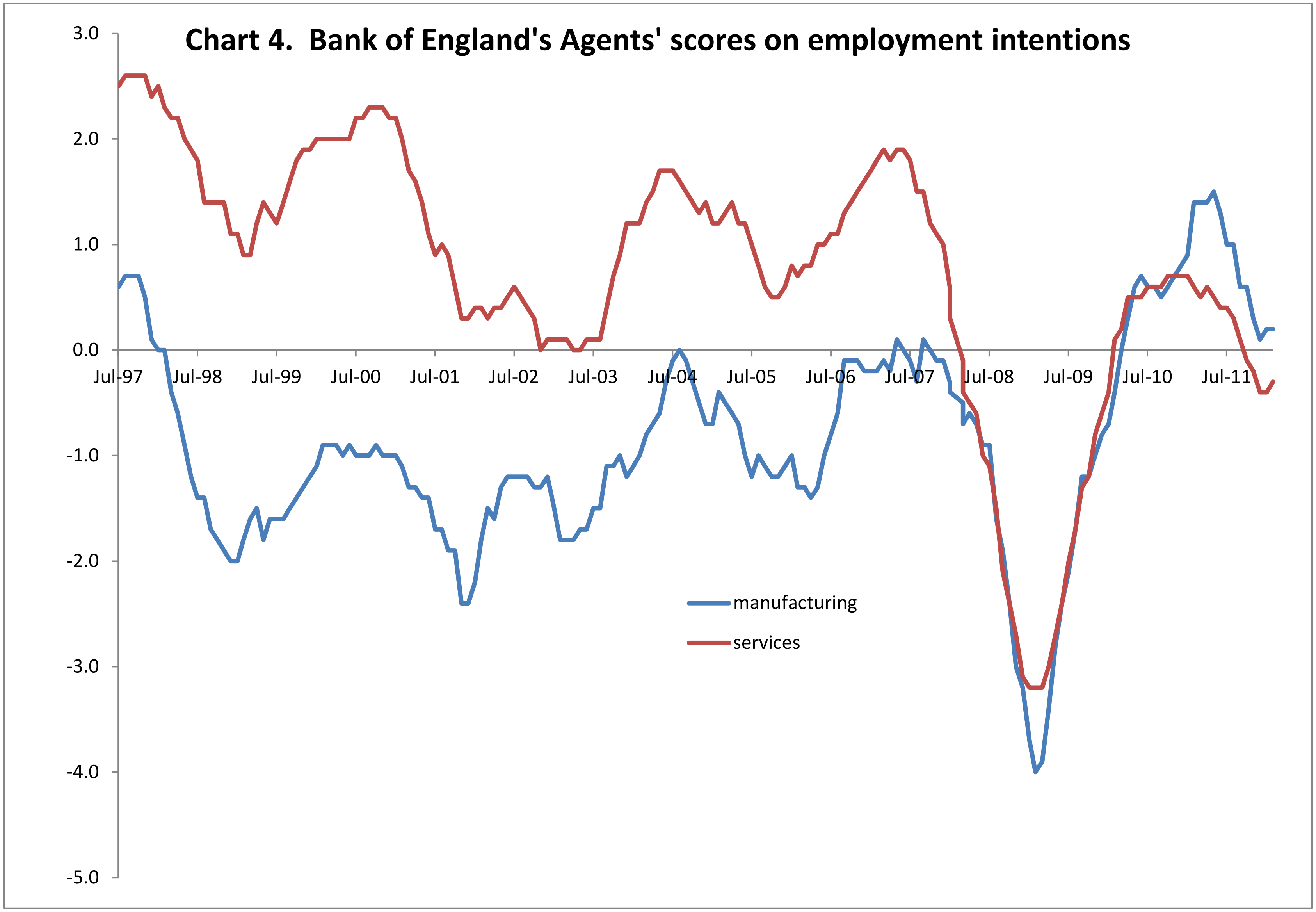


Chart 4. Bank of England's Agents' scores on employment intentions
3.0
2.0
1.0
0.0
-1.0
-2.0
-3.0
-4.0
-5.0
Jul-97
Jul-98
Jul-99
Jul-00
Jul-01
Jul-02
Jul-03
Jul-04
Jul-05
Jul-06
Jul-07
Jul-08
Jul-09
Jul-10
Jul-11
manufacturing
services

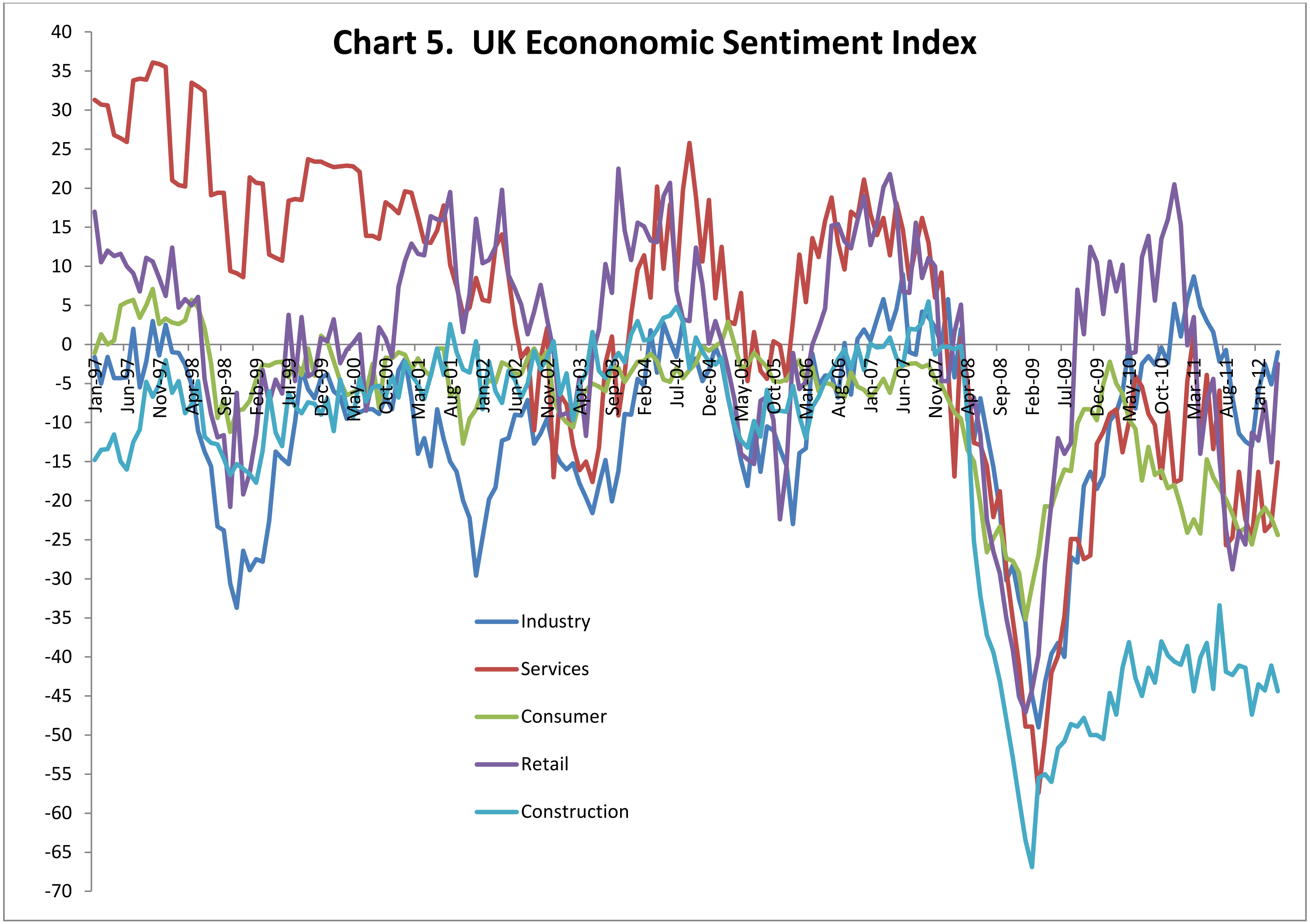


Chart 5. UK Econonomic Sentiment Index
40
35
30
25
20
15
10
5
0
-5
-10
-15
-20
-25
-30
-35
-40
-45
-50
-55
-60
-65
-70
Jan-97
Jun-97
Nov-97
Apr-98
Sep-98
Feb-99
Jul-99
Dec-99
May-00
Oct-00
Mar-01
Aug-01
Jan-02
Jun-02
Nov-02
Apr-03
Sep-03
Feb-04
Jul-04
Dec-04
May-05
Oct-05
Mar-06
Aug-06
Jan-07
Jun-07
Nov-07
Apr-08
Sep-08
Feb-09
Jul-09
Dec-09
May-10
Oct-10
Mar-11
Aug-11
Jan-12
Industry
Services
Consumer
Retail
Construction

-

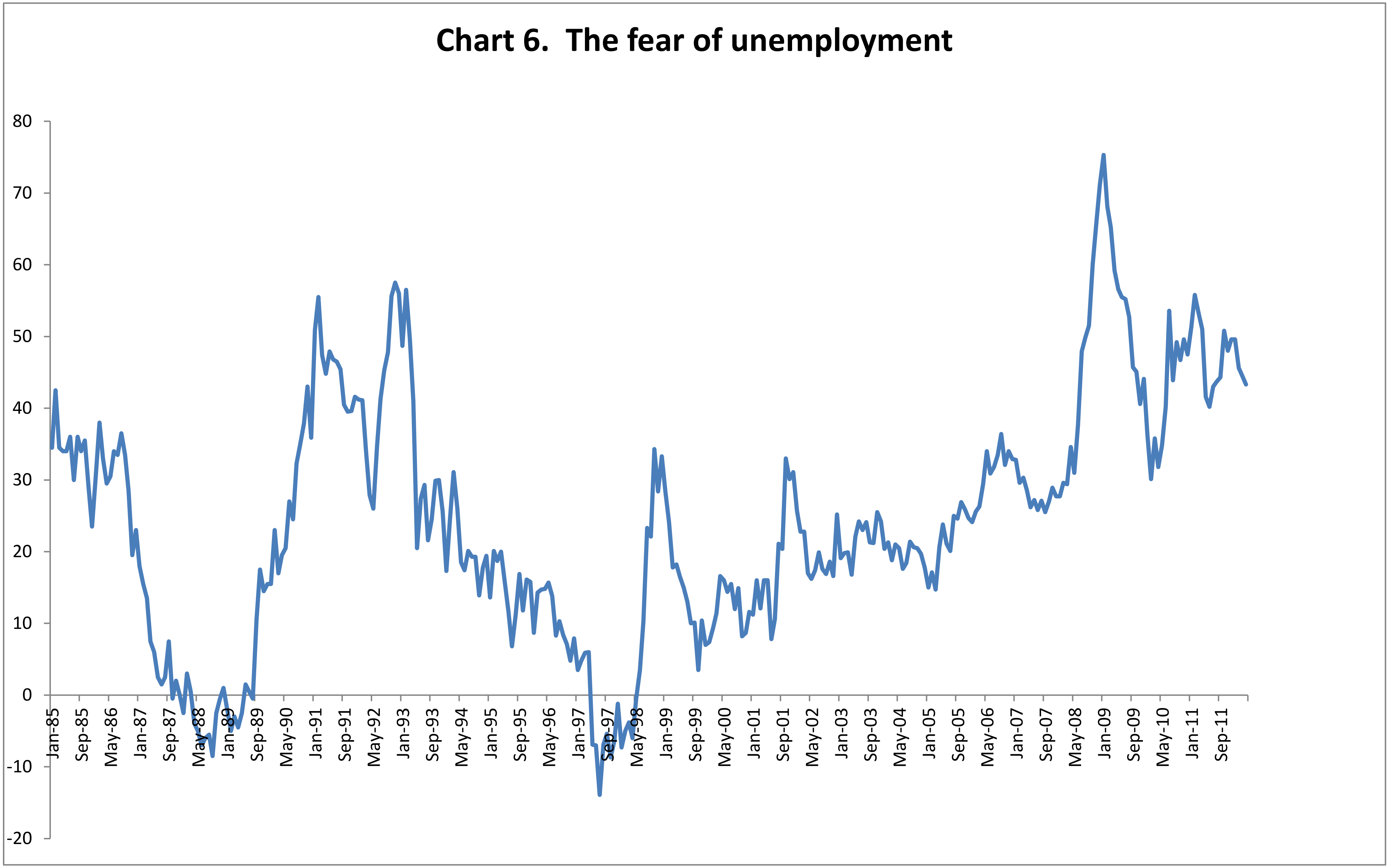
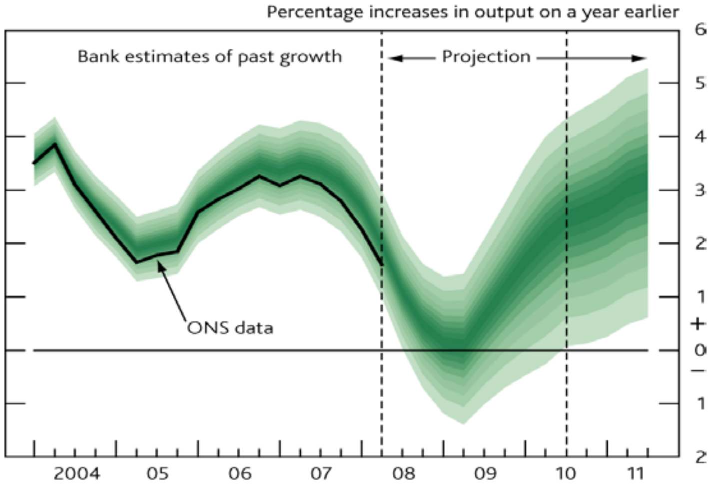


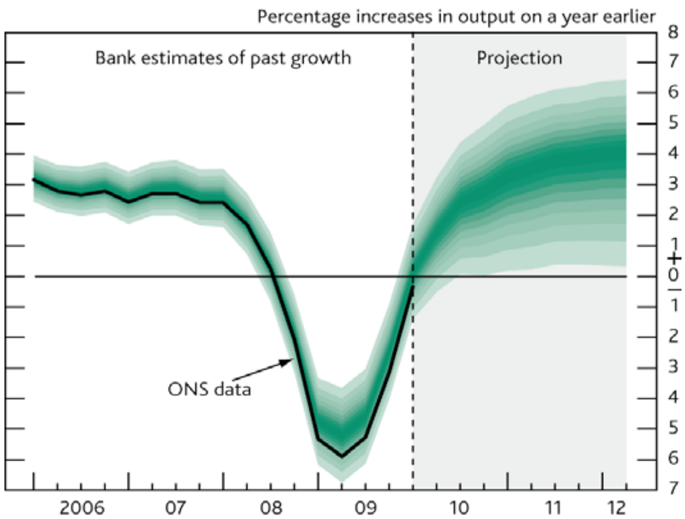
Chart 6. The fear of unemployment
80
70
60
50
40
30
20
10
0
-10
-20
Jan-85
Sep-85
May-86
Jan-87
Sep-87
May-88
Jan-89
Sep-89
May-90
Jan-91
Sep-91
May-92
Jan-93
Sep-93
May-94
Jan-95
Sep-95
May-96
Jan-97
Sep-97
May-98
Jan-99
Sep-99
May-00
Jan-01
Sep-01
May-02
Jan-03
Sep-03
May-04
Jan-05
Sep-05
May-06
Jan-07
Sep-07
May-08
Jan-09
Sep-09
May-10
Jan-11
Sep-11

Chart 6. MPC forecasts of GDP, 2008-2012

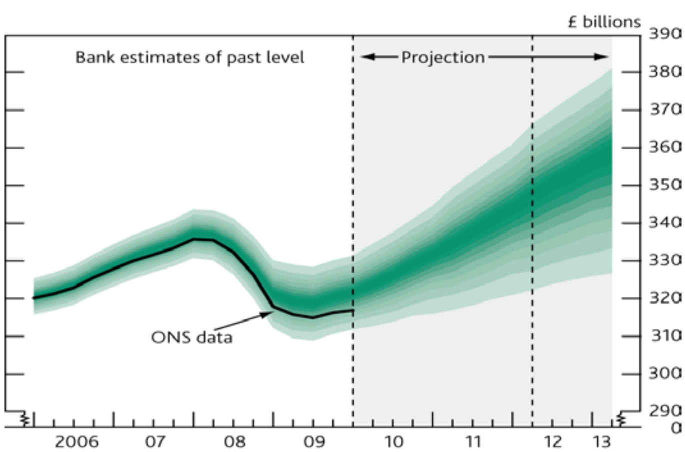
A) August 2008. GDP Growth at market interest rates



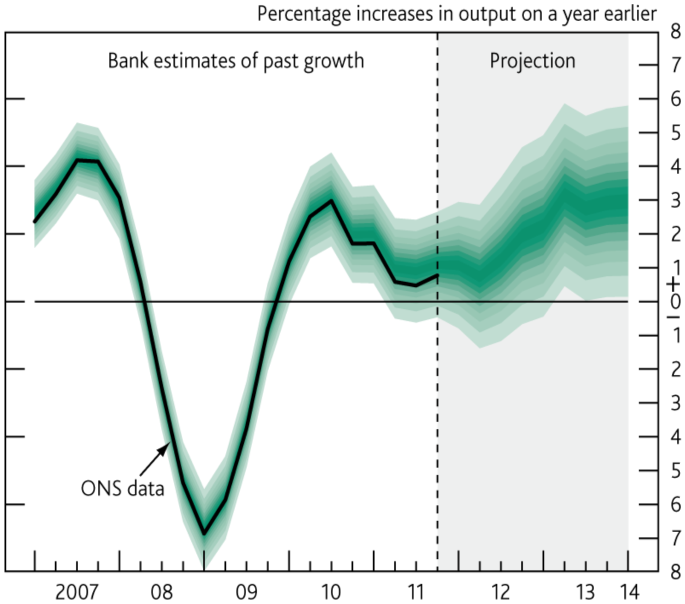
B) May 2010. GDP Growth at constant interest rate 0.5% and £200 billion asset purchases



C) May 2010 Projection of the level of GDP based on market interest rate expectations and £200 billion asset purchases



D) February 2012. GDP Growth at constant interest rate 0.5% and £325 billion asset purchases



E) May 2012 GDP Growth at constant interest rate 0.5% and £325 billion asset purchases

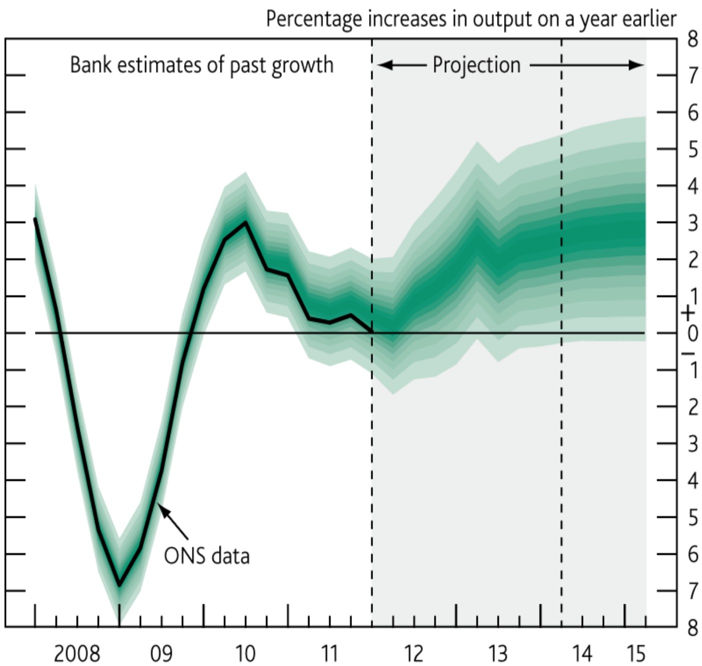


Table 1. Quarterly GDP and Revisions as of May 2012 (%), quarter on quarter

	Preliminary	Latest	Revision
Darling Recovery			
2009Q3	-0.4	0.2	+0.6
2009Q4	0.1	0.7	+0.6
2010Q1	0.2	0.4	+0.2
2010Q2	1.1	1.1	0
2010Q3	0.8	0.7	-0.1
D) Osborne Collapse			
2010Q4	-0.5	-0.5	0
2011Q1	0.5	0.2	-0.3
2011Q2	0.2	-0.1	-0.3
2011 Q3	0.5	0.6	+0.1
2011 Q4	-0.2	-0.3	-0.1
2012Q1	-0.2	-0.2	n/a
Average revision			
2006Q1-2012Q1			-0.1

Table 2. Cumulative Quarterly GDP Growth rates (%)

	2008Q1-2009Q2	2009Q3-2011Q4
Australia	2.2	6.2
Austria	-4.1	6.4
Belgium	-3.0	4.8
Canada	-3.7	7.2
Chile	-0.1	14.9
Czech Republic	-4.3	4.8
Denmark	-8.2	2.8
Estonia	-19.3	11.2
Finland	-10.6	8.1
France	-3.6	3.6
Germany	-5.6	7.3
Greece	-2.1	-7.4
Hungary	-6.5	3.3
Iceland	-9.2	1.5
Ireland	-11.7	-0.4
Israel	1.7	11.8
Italy	-6.7	2.0
Japan	-7.0	4.3
Korea	-0.6	12.7*
Luxembourg	-7.4	6.3
Mexico	-7.9	12.4
Netherlands	-4.5	3.1
New Zealand	-3.6	3.5
Norway	-3.4	3.5
Poland	3.4	10.3
Portugal	-3.8	-1.4
Slovak Republic	-5.9	9.4
Slovenia	-7.1	1.0
Spain	-4.0	0.2*
Sweden	-7.5	9.8
Switzerland	-1.6	5.4
Turkey	-7.4	19.8
United Kingdom	-7.2	2.9*
United States	-5.2	6.6*
Euro area (17 countries)	-5.1	3.6
European Union (27 countries)	-5.4	3.9
Argentina	2.3	20.7
Brazil	0.9	12.1
China	0.0	10.6
India	6.5	20.2
Indonesia	7.5	16.0
Russian Federation	-7.3	12.1
South Africa	-0.5	7.4

Notes: *Through 2012Q1. Source: OEC

Table 3. OBR's Forecasts (Source: Office of Budget Responsibility)

A) Budget June 2010 Forecast

	Percentage change on a year earlier, unless otherwise stated						
		Forecasts					
	2009	2010	2011	2012	2013	2014	2015
Gross domestic product (GDP)	-4.9	1.2	2.3	2.8	2.9	2.7	2.7
Expenditure components of GDP							
Domestic demand	-5.3	1.6	1.4	1.9	2.2	2.2	2.3
Household consumption[3]	-3.2	0.2	1.3	1.7	2.1	2.2	2.2
General government consumption	2.2	1.7	-1.1	-2.0	-2.3	-3.0	-2.1
Fixed investment	-14.9	-0.5	3.9	7.9	8.8	8.0	6.9
Business	-19.3	1.4	8.1	10.0	10.9	9.5	8.2
General government	15.7	-4.9	-19.0	-8.5	-6.6	0.6	2.0
Private dwellings	-19.7	-6.5	5.6	8.2	8.5	7.1	6.6
Change in inventories[4]	-1.2	1.2	0.4	0.0	0.0	0.0	0.0
Exports of goods and services[5]	-10.6	4.3	5.5	6.3	6.1	5.9	5.7
Imports of goods and services[5]	-11.9	5.6	2.1	2.7	3.6	4.0	4.2
Inflation							
CPI (Q4)	2.1	2.7	2.4	1.9	2.0	2.0	2.0
Labour market							
Employment (millions)	29.0	28.8	28.9	29.2	29.5	29.8	30.1
Wages and salaries	-1.0	1.2	2.3	3.1	4.9	5.4	5.4
Average earnings[7]	1.0	2.1	1.9	2.3	3.8	4.4	4.4
ILO unemployment (% rate)	7.6	8.1	8.0	7.6	7.0	6.5	6.1
Claimant count (Q4, millions)	1.6	1.5	1.5	1.4	1.3	1.2	1.1

B) March 2012 Budget forecast

	Percentage change on a year earlier, unless otherwise stated						
	Outturn			Forecast			
	2010	2011	2012	2013	2014	2015	2016
Gross domestic product (GDP)	2.1	0.8	0.8	2.0	2.7	3.0	3.0
Expenditure components of GDP							
Household consumption[2]	1.2	-0.8	0.5	1.3	2.3	3.0	3.0
Business investment	-2.1	0.2	0.7	6.4	8.9	10.2	10.1
General government consumption	1.5	0.3	0.5	-1.1	-2.1	-2.8	-2.7
General government investment	7.8	-13.0	-5.0	-3.6	0.1	0.4	-1.4
Net trade[3]	-0.5	1.2	0.4	0.5	0.3	0.2	0.1
Inflation							
CPI	3.3	4.5	2.8	1.9	1.9	2.0	2.0
Labour market							
Employment (millions)	29.0	29.2	29.1	29.2	29.4	29.7	30.0
Average earnings[4]	2.4	1.2	2.6	3.1	4.3	4.5	4.5
ILO unemployment (% rate)	7.9	8.1	8.7	8.6	8.0	7.2	6.3
Claimant count (millions)	1.50	1.53	1.65	1.64	1.52	1.35	1.19

Table 4. Change in fiscal expenditures and revenues as a percentage of GDPby category between 2011 and 2012 (percentage points). Source: Table 3.1 ILO World of Work 2012

	Total expenditure	Total revenue
Australia	–0.5	1.3
Austria	–0.6	–0.1
Canada	–0.4	–0.1
Denmark	0.9	–0.6
Finland	0.7	1.7
France	–0.4	0.4
Germany	–0.3	0.6
Greece	0.2	1.6
Ireland	–1.8	–0.4.4
Japan	–0.8	–0.6
Korea,	–0.6	–0.4
Norway	0.2	–2.0
Portugal	–2.3	–0.9
Spain	–0.9	-0.3
Sweden	–1.3	–2.3
Switzerland	–0.1	0.03
United Kingdom	–2.8	–0.3
United States	–1.7	2.2

In the United States, value corresponds to change in spending on social security mandatory programmes. In Australia, it corresponds to change in spending on social welfare and health. In France, the change is due to a reduction of special intervention social programmes, such as Aid for Social Housing (Aide pour le lodgement (APL)), the Active Solidarity Revenue (Revenu de solidarité active (RSA)) or the Disabled Adult Allowance (Allocation pour adulte handicapé (AAH)). In Germany, figures correspond to the Federal Government budget plan and, in Sweden, to the Central Government budget plan.

Source: IILS estimates based on planned government budgets for 2012, national sources.Source: Table 3.1 ILO World of Work 2012.