Economics and Reality

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Economics and Reality

• How reality in the form empirical evidence does or does not influence economic thinking and theory?

• What is the role of:
  ➢ Calibration
  ➢ Statistical Inference
  ➢ Structural Changes
Economics and Reality

• **General Perspective:**
  - Economics is a **Science**
  - Economics is an **Art**
  - Economics is a **Competitions.**
  - Economics is **Politics**
Economics and Reality

• Specific Cases:
  o Is there a Phillips Curve?
  o Are Prices Sticky?
  o Does Contractionary Monetary Policy lead to a Contraction in Output?
  o What causes Business Cycles?
Economics is a Science

- It concerns itself with the **description** and **explanation** of economic phenomena.

  - “Positive economics is in principle independent of any particular ethical position or normative judgments” (Friedman, 1953).

  - It describes “what is”, as opposed to normative economics, which deals with “what ought to be” (Keynes, 1890).
Economics is a Science

- Economics as a science **induces** theory from empirical observations and **deduces** empirical predictions from theories.
  - Empirically grounded inductive Approach
  - Theoretical lead deductive Approach

- Both are of **importance** and mutually **complement** each other.
  - Not every single researcher may proceed the whole way
  - Specialization enhances productivity.
Economics is a Science

Does empirical evidence influence economic thinking and theory?

- Reality guides Economics as in any Scientific discipline.
- Empirical evidence influences and should influence economics.
Economics is an Art

- Are Economist searching for “Theory of Ever things”? No!
  - They arm themselves with many theories
  - Study a narrow subset of forces at work
  - Finally, answer the particular question at hand.

- Simplification and reduction to the core, is the key to success in the scientific community of economists!
  - A theory or an empirical investigation should be as simple as possible!
  - But not too simple!
Economics is an Art

• The winning theory ignores many ugly details of reality, replicates a selected set of key facts.

• So a good theory is false by design!

• Therefore, a theory that cannot be rejected by data, is not good, or data is yet inconclusive!

• Developing econometric techniques that deal with those aspects of theory is necessary.
Economics is an Art

- Does empirical evidence influence economic thinking and theory?

Empirical Evidences influence economic thinking by guiding theorists to design theories

- that are beautiful and minimalistic
- that connect to a select set of key facts.
Economics is a Competition of Ideas

- Which direction of research is correct?
- Which line of inquiry is fruitful?
- Which argument is convincing?

- Existing explanations and theories are sometimes abandoned, when empirical evidence falsifies a crucial hypothesis.
Economics is a Competition of Ideas

- Existing explanations and theories are sometimes abandoned when ...
  - Empirical evidence falsifies a crucial hypothesis.
  - More likely, because a newer theory is more convincing.

- As a byproduct, old theories are never really discarded ...
  - One can never take a first look a second time.
  - It may be impossible for the science as a whole
Economics is a Competition of Ideas

Does empirical evidence influence economic thinking and theory?

- **New theories** predict or explain **new facts**.
- Old theories stay around, whether they explain existing new and old facts or not.
Economics is Politics

• Economic ideas play a powerful role in economic policy.

• There is therefore another competition of ideas: those that are powerful and convincing in the arena of practical politics.
Economics is Politics

 ➢ While economics as a science treasures …
   o the new and thought-provoking insight
   o the new and creative argument
   o the new and powerful evidence

 ➢ politics is skeptical of new logical arguments and stays close …
   o to the true and proven
   o to views formed long ago
   o to formulations that continue to convince the voters.

 Ideas do win, but they win with a long delay!
Economics is Politics

Does empirical evidence influence economic thinking and theory?

• Economic thinking at the practical level is thick-skinned and conservative.
• It is rarely influenced by fresh economic theory or empirical evidence unless ...
• It fits well with an agenda that had been established elsewhere already.
Is there a Phillips curve?

Phillips Curve:

- A tradeoff between unemployment and inflation
- Originally documented by Phillips (1958) as an empirical relationship in the United Kingdom from 1913 to 1948.
- Profoundly influenced economic thinking.
- May be a poster child for the success of empirical evidence influencing economic thinking.
* Lucas (1976) : Seemingly stables relationships in top two, cannot be expected to remain stable once a policy seeks to exploit it.


* Conventional view: there still is a Phillips curve but at a more sophisticated level

* Radical view (what seems at the first look): There is in fact no Phillips curve
Is there a Phillips curve?

- Do we know what the empirical evidence says?
- Are we “discovering” the empirical evidence that fits our view of the world that was established long ago?
- Are we looking at the data with glasses tinted by our theoretical prejudices?
- Have we been ignoring the empirical evidence all along?
- Or has the empirical evidence perhaps always been there, as a number of macro-econometricians forcefully argue?
Is there a Phillips curve?

- Does empirical evidence influence economic thinking and theory *in this case*?

One may ask: do we truly know what the empirical evidence says?
Are Prices Sticky?

- Sticky Prices:
  - Theory explanation of Phillips curve
  - Exploitability Potential of Philips curve for policy

- Macro research in the 80s has often been dismissed as “unrealistic”, because it did not feature sticky prices.

- It seemed self-evident to observers that prices are sticky indeed.
Some “icicles” hanging from more stable “reference price” level. Icicles represent sales.

* ignore the sales prices, and focus on the reference price?

* price sensitive customers will pay attention to sales and sales prices

* Do you see any stickiness?

* What about newspapers, magazines ...?
Are Prices Sticky?

- Again, it seems hard to say, what exactly the empirical facts are.
- The closer one looks, the more one feels that we are asking the wrong question of the data.
Are Prices Sticky?

- Does empirical evidence influence economic thinking and theory in this case?

- Theory has yet to ask the interesting questions that the data actually answers.
Does contractionary monetary policy lead to a contraction in output?

- Does empirical evidence influence economic thinking and theory *in this case*?

  - The influence is only there, if it fits the a priori theorizing, while other evidence is dismissed.

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What Causes Business Cycles?

Does empirical evidence influence economic thinking and theory in this case?

- events destroy the consensus on which these models were built...
- economic science turns its attention into a different direction...

When ....

- calibration had been replaced by statistical inference.
- structural change were investigated in a sophisticated manner.
Summary

The summary is this. Reality, i.e. empirical evidence influences economic thinking and theory and vice versa – but it does not do so in textbook fashion. Jolted by new empirical and theoretical insights and subjected to the fickleness of attention, the frontier of our science lurches forward to the unknown territory of ever more profound understanding. If it moves in circles, it hopefully does so on ever higher levels. Practical economics and economic policy follows, with considerable distance. Perhaps, this is how it has to be.