



**The Past and Current Failure of
Economic Theory and Practice.
Andrew Smithers**

**Hyman P. Minsky Conference
Berlin, 26th – 27th November, 2012.**

Slide 1. Poor Theory and Bad Practice.

- **The weakness of theory caused the financial crisis.**
- **Its strength prevented a slump.**
- **Its weakness is now inhibiting recovery.**

Slide 2. Bad Epistemology at the Heart of Bad Theory.

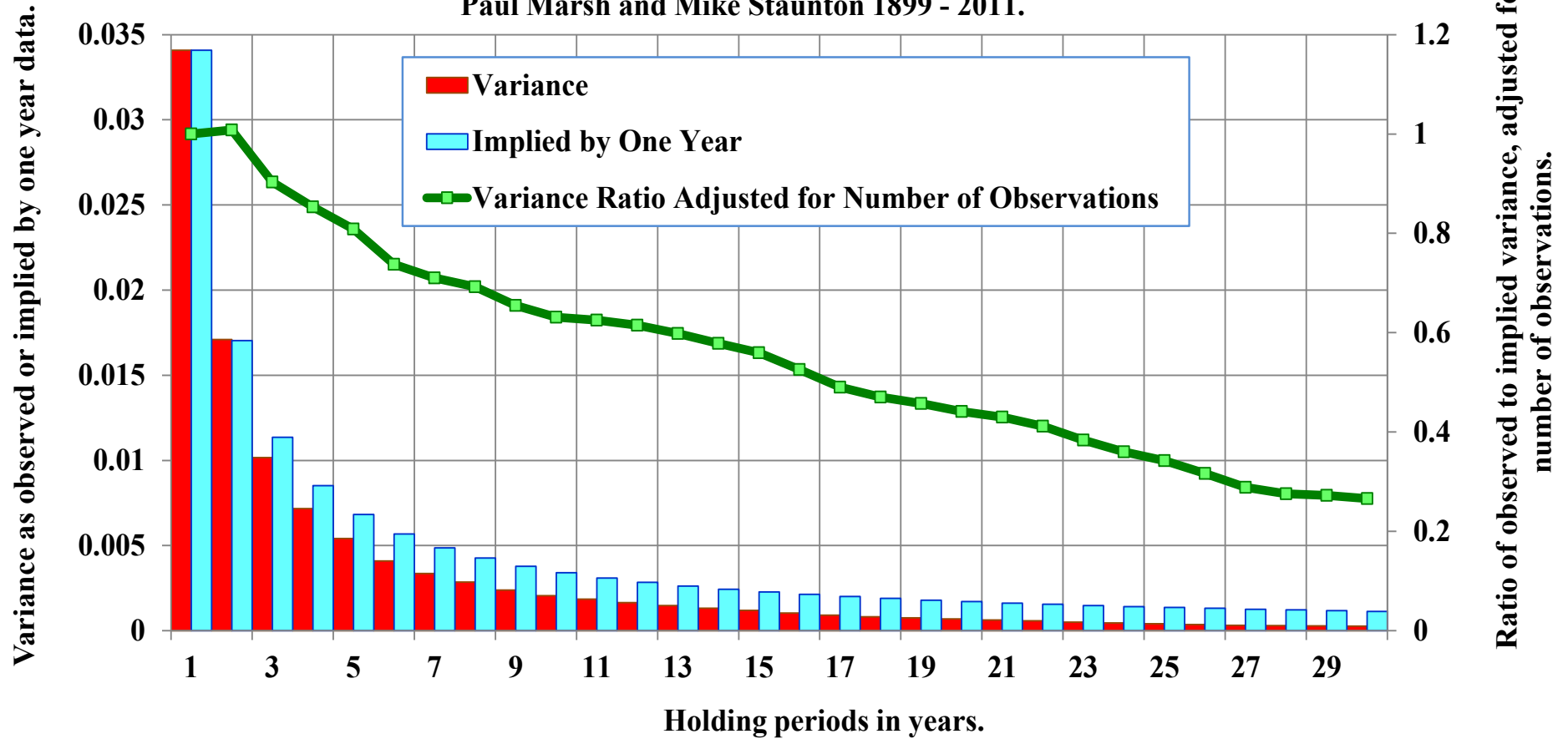
- **David Deutsch claims that this is the root of much bad science.**
- **I claim that this is particularly true of economics.**
- **Economics is a science which is frequently pursued unscientifically.**
- **The Efficient Market Hypothesis is an outstanding example.**

Slide 3. The EMH.

- **Testable in its random walk form, but fails the test.**
- **Real equity returns exhibit negative serial correlation (Slide 4).**
- **No revised version of the EMH is testable (so far).**
- **It therefore falls the wrong side of the demarcation between science and non-science.**

Slide 4. US: Variance Compression of Real Equity Returns 1801 - 2011.

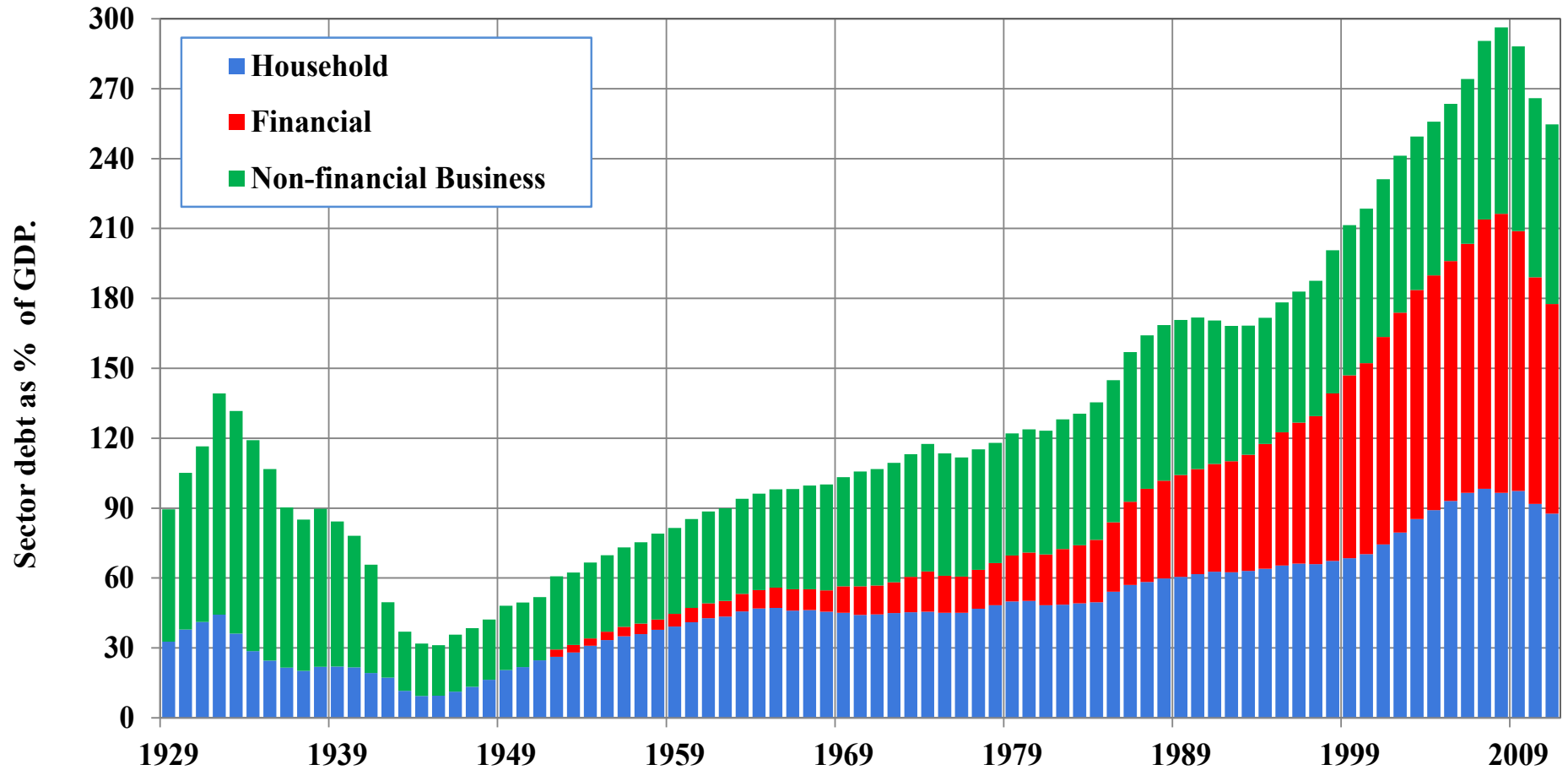
Data Sources: Jeremy Siegel 1801 - 1899 and Elroy Dimson, Paul Marsh and Mike Staunton 1899 - 2011.



Slide 5. The Failure of the Neoclassical Synthesis.

- **Financial crises are caused by excessive debt (Slide 6 - the fundamental cause).**
- **They are triggered by falls in asset prices (the proximate cause).**
- **Quantitative easing drives up asset prices.**
- **With debt high (Slide 6), this increases the risk of another crisis.**

Slide 6. US: Private Sector Debt as % of GDP.

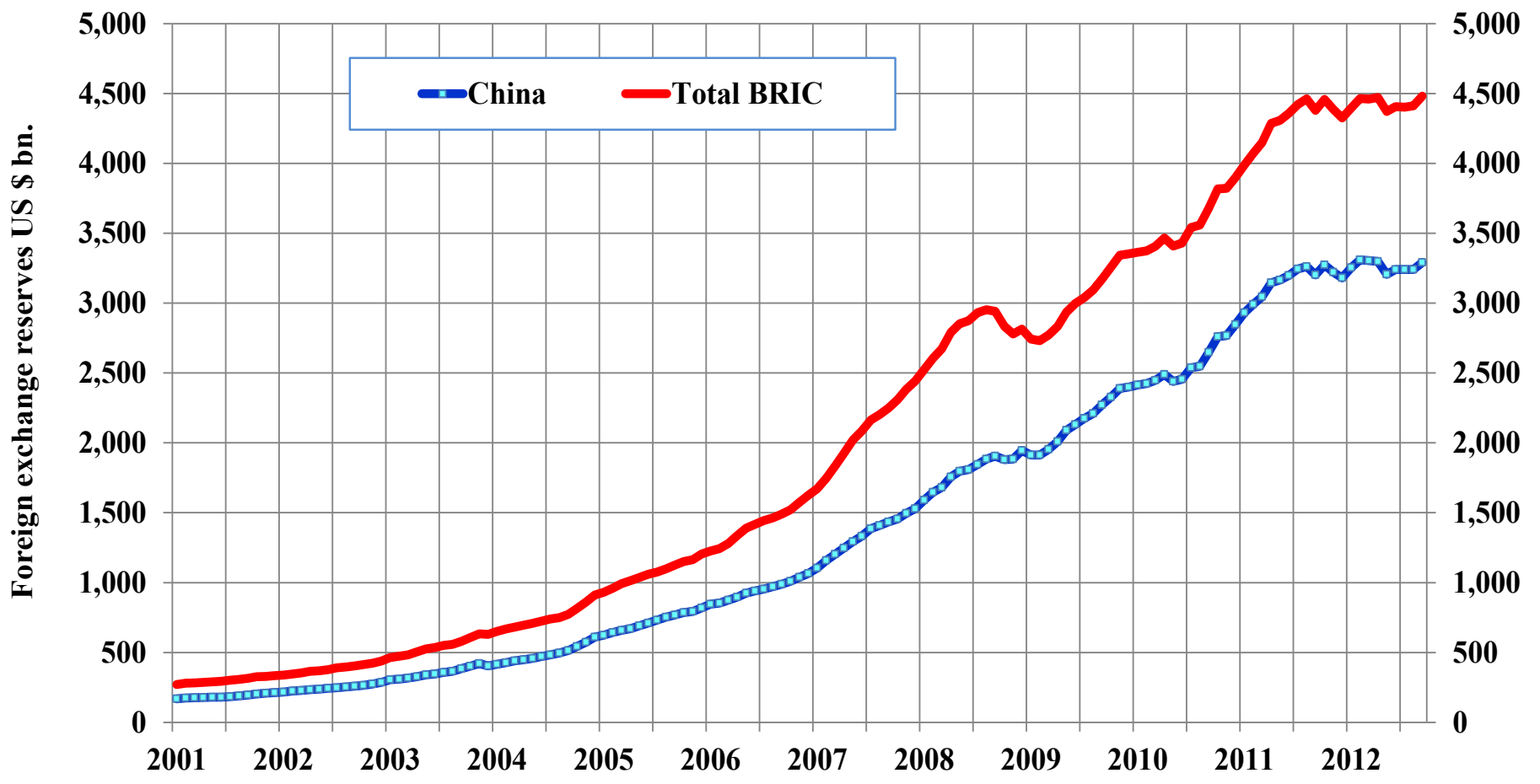


Data Sources: Bureau of the Census, Federal Reserve (Z1 Table D3)
and NIPA Table 1.1.5.

Slide 7. The Post-War Era is Over.

- **“Keynesian countries” (the US, Japan and the UK) have massive deficits.**
- **Others disdain deficit financing.**
- **Germany imposes its views on the rest of the Eurozone.**
- **China and other emerging economies prefer currency intervention (Slide 8).**

Slide 8. BRIC Foreign Exchange Reserves.

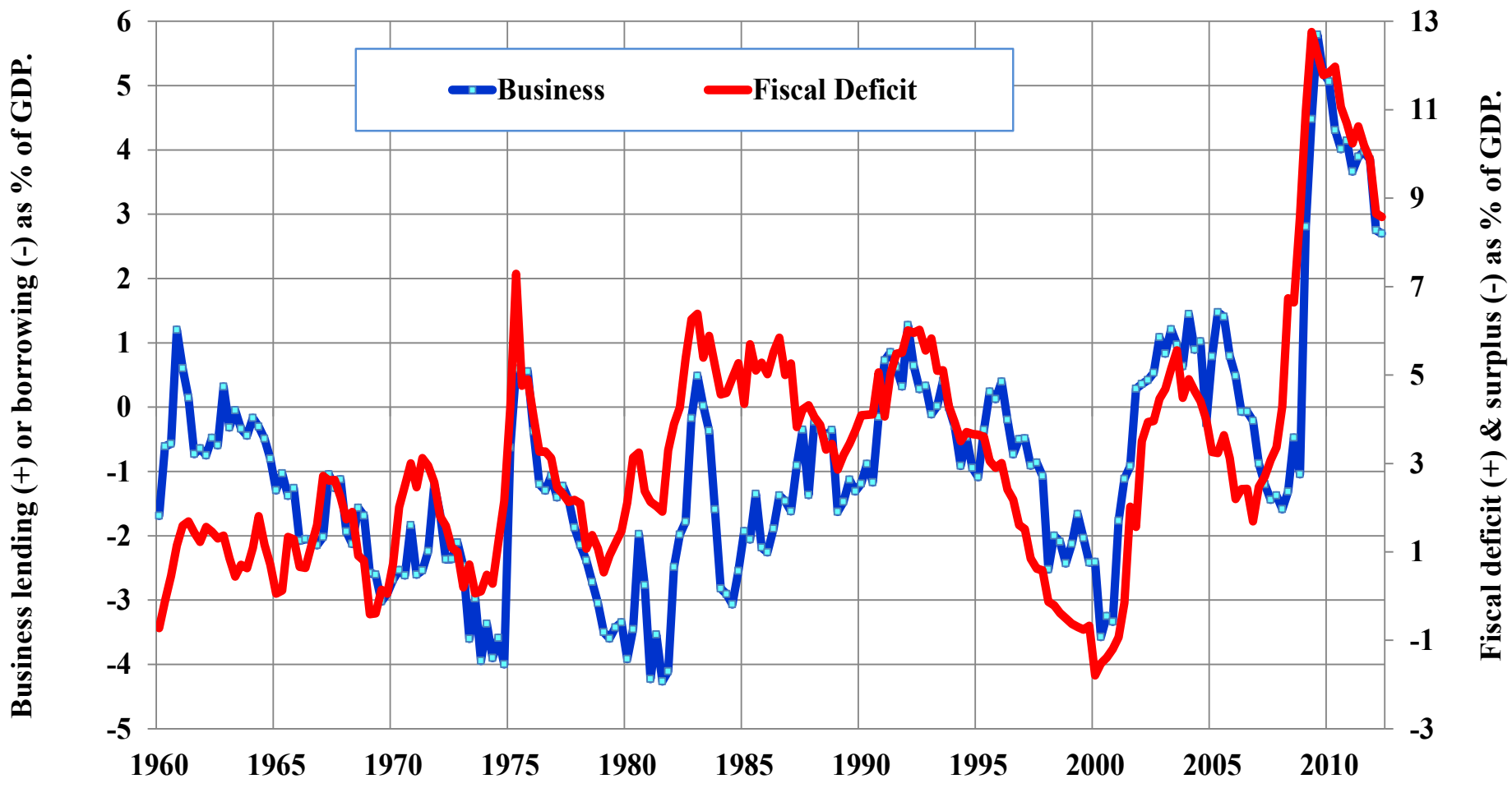


Data Sources: National Data via Ecwin.

Slide 9. Poor Economics Now Inhibits Recovery.

- **There is a huge ex-ante savings' surplus in the business sector (Slide 10).**
- **This is, as always, why we need fiscal deficits.**
- **The correlation coefficient between business surpluses and fiscal deficits is 0.83.**
- **But this time it's structural, not cyclical.**

Slide 10. US: Business Cash Flow and Budget Deficit.



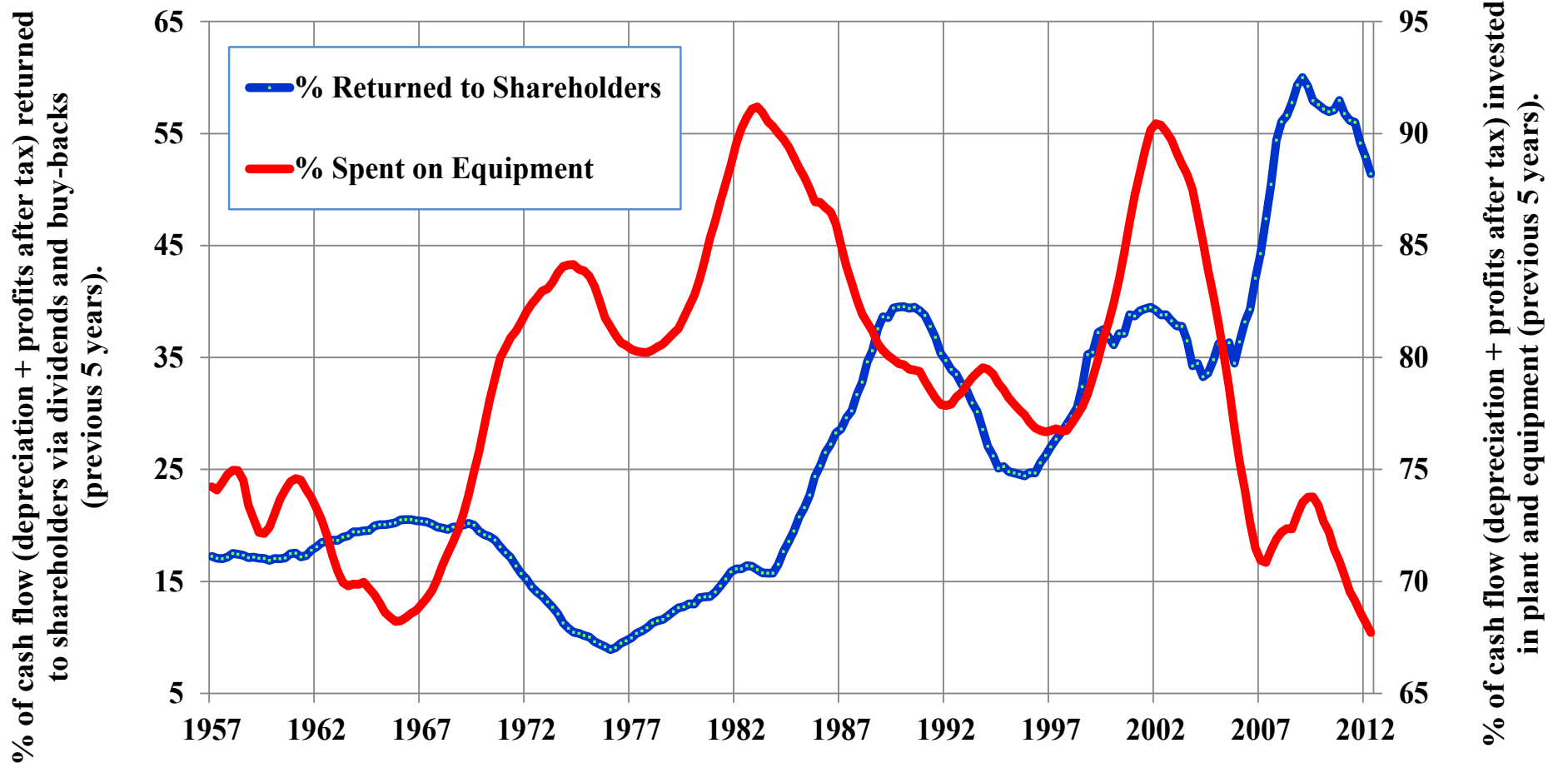
Data Source: NIPA Tables 1.1.5 & 5.1.

Slide 11. The Change in Management Behaviour.

- **In the US and UK, management is now paid by bonus and options rather than by salary.**
- **In the US by 2008 the salary component had fallen to only 17% of average total pay.⁵**
- **Changes in incentives cause changes in behaviour.**
- **Managements choose buy-backs over investment (Slide 12).**

⁵ *CEO Compensation* by C. Frydman and D. Jenter published in the Annual Review of Financial Economics 2(1) 57-102.

Slide 12. US: Non-financial Companies' Use of Cash Flow.

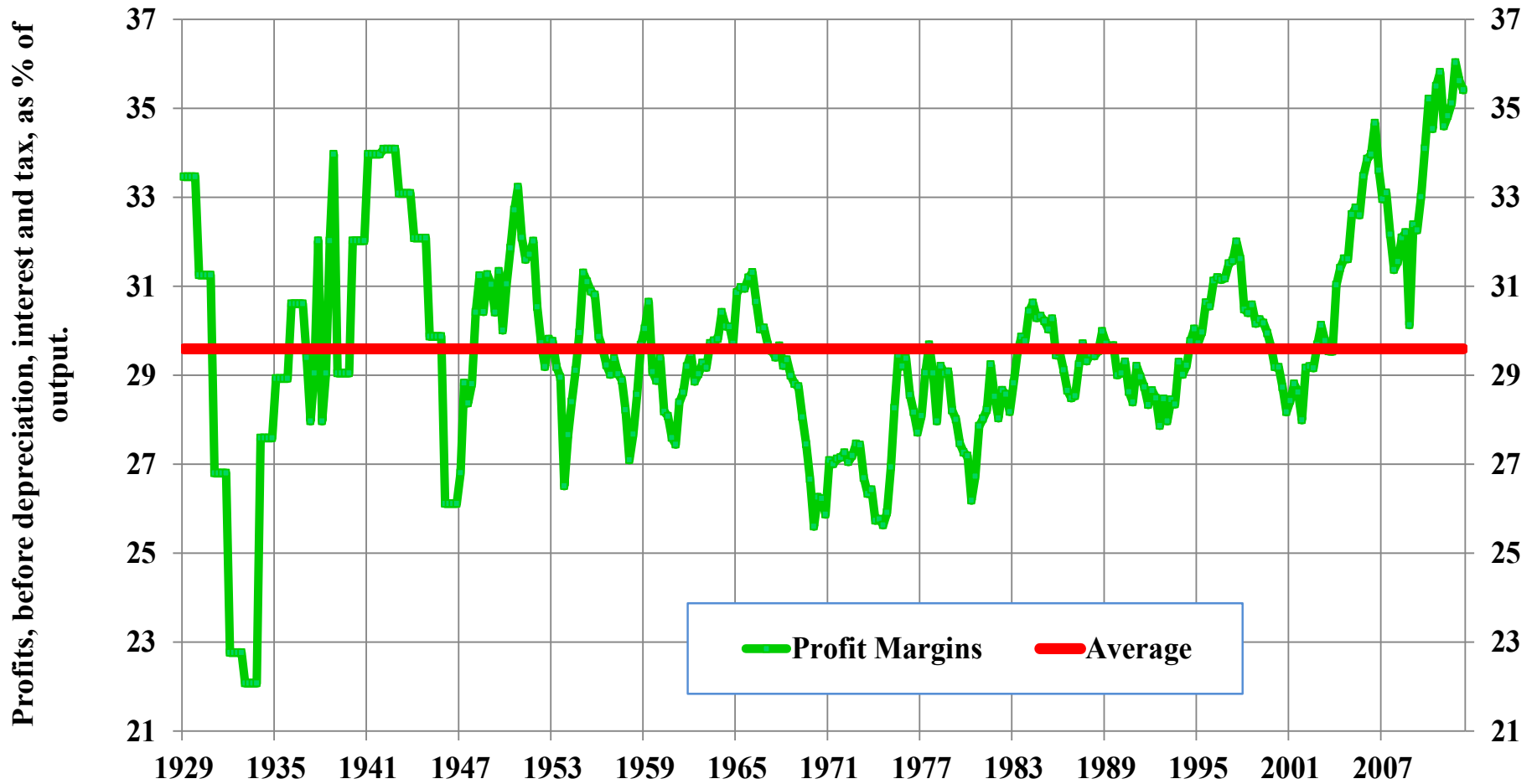


Data Source: Z1 Table F.102.

Slide 13. The Evidence of Changed Behaviour.

- **Massive buy-backs and low investment (Slide 12).**
- **Profit margins at record highs (Slide 14).**
- **Huge volatility of published compared to “real” profits (Slide 15).**

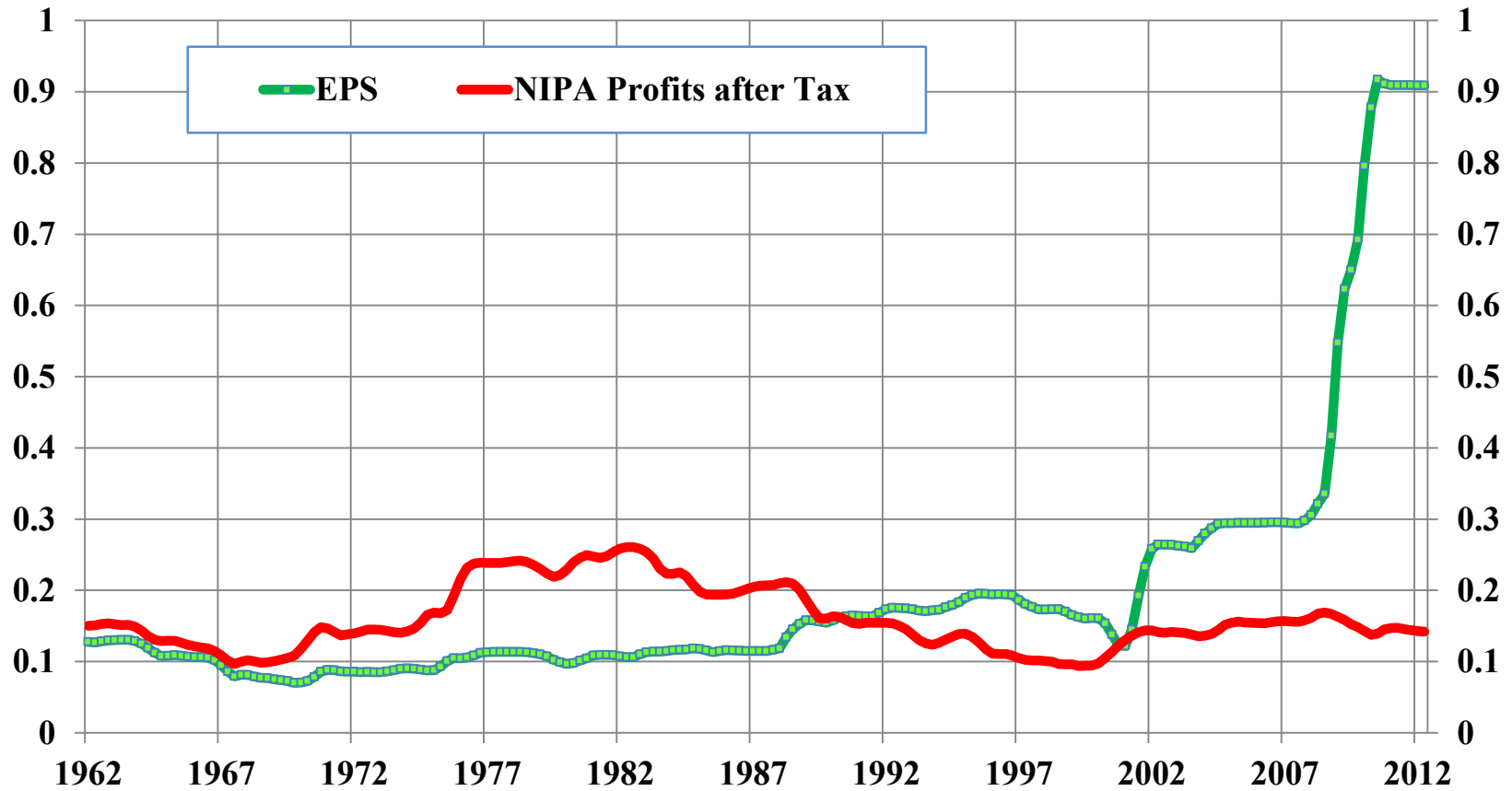
Slide 14. US: Profit Margins 1929 - Q2 2012.



Data Source: NIPA Table 1.14.

Slide 15. US: Volatility of EPS and NIPA Profits after Tax.

Standard deviation over past 10 years in EPS and profits after tax measured at constant prices.



Data Sources: NIPA Table 1.14 and Robert Shiller's website.

Slide 16. Conclusions.

- **We are in a liquidity trap – so quantitative easing increases risks without stimulating the economy.**
- **The business sector's ex-ante savings' surplus is structural not cyclical.**
- **It is a by-product of the bonus culture.**
- **We need to reduce the business sectors' saving surplus.**
- **Fiscal deficits are an analgesic, not a cure.**