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Economics Rules: Why Economics Works, When It Fails, and How to Tell the Difference


“One conventional view of economists is that they are knee-jerk market fundamentalists: they think the answer to every problem is to let the market be free. Many economists may have that predisposition. But it is certainly not what economics teaches. The correct answer to almost any question in economics is: It depends. Different models, each equally respectable, provide different answers”

Summary

This book’s roots lie in a course on political economy that Dani Rodrik taught at Harvard for several years, and which led him to reflect on the strengths and weaknesses of economics. As a subject, economics is often criticised for being sterile and outdated; and having turned its back on the development of major social theories such as those of Adam Smith or Karl Marx. However, for Rodrik, the strength of economics lies in its small-scale theories – meaning the type of contextual thinking that clarifies cause and effect and so explains social reality – even if only partially. In the author’s opinion, a modest science practiced with humility may be more useful than searching for the keys to global wealth and poverty, or universal theories on capitalism. This thought process led Rodrik to write Economics Rules.

Economists are good at providing circumstantial explanations about the workings of society. They also excel at offering clarifications on how markets (and government interventions) combine with contextual factors to produce a range of consequences for efficiency, equality, and economic growth. However, economists also tend to enunciate economic laws for universal application regardless of the context. This book aims to overcome this divide. Rodrik’s message to economists is that they need to improve the narrative on the type of science they practice. He uses an approach which is more philosophical than economic to develop an alternative framework that emphasises the useful work being carried out by economists, as well as the major errors that are being committed. Economists, he argues, should not seek universal explanations or recipes for application regardless of context. Instead, they should
develop economic models (or partial maps) that show the way in small areas. Taken together, the sum of these small-scale models offers the best guide to understanding the endless hills and valleys that form our social experience. For non-economists, the author’s main message is that much of the principal criticism levied against economics loses significance under the model proposed by the author. Certainly, there is much to criticise about economics as a discipline. However, Rodrik stresses that there is also much to learn.

The author

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Key ideas and opinion

The world becomes a better place when economics gets it right. However, economics often fails. To analyse why economics sometimes works and sometimes fails, Dani Rodrik examines the models – the usually abstract mathematical frameworks that economists use to understand the world. Such models are both the strength and the Achilles’ heel of economics. They are also what make economics a science – not a science like quantum physics or molecular biology, but a science nevertheless. Economics does squeeze into a single model, but encompasses a collection of models. The discipline develops as a science by expanding its library of models and improving the description of how these models work. However, economists often misuse their models, partly because they often take the natural sciences as their example. Thus, they mistake ‘a model’ for ‘the model’, and then insist that it is universally relevant and applicable. For Rodrik, economists must overcome this temptation and choose their models carefully. They also need to move between various models more fluidly as circumstances change.

Economists build models that capture specific aspects of social interactions. Such interactions usually occur in transactions for all types of goods and services, and they take place in markets at local, regional, national, and international levels. The traditional focus of economists is studying how markets function: are resources used efficiently? Can performance be improved? If so, how? Economists build models to analyse and understand the effects of markets. The familiar supply-demand model is the focus of these models. This model works in an artificial world populated by a large number of consumers and producers that is known as the ‘perfectly competitive
market’. Everyone in this artificial world pursues their own economic interests, and nobody has the power to affect market prices. This model, says the author, neglects many factors: people may have non-material motivations; rationality is often overshadowed by cognitive or emotional mistakes; and producers may behave as monopolists, etc.

However, this model still explains some fundamentals on how markets work in the real world. Some fundamentals are obvious, such as an increase in production costs raises market prices and reduces demand and supply; or when energy costs increase, so electricity bills increase, and households find ways to save on heating and electricity. But other fundamentals are less obvious: for example, the fact that whether a tax is imposed on a producer or consumer has nothing to do with who ends up paying for it. A tax may be applied to oil companies, but it could be consumers who end up paying for it, through higher gas prices; or an additional cost may be put on consumers in the form of a sales tax, but the oil companies may ultimately assume the cost by lowering prices. It all depends on the price elasticity of supply and demand.

Let’s now consider a very different model, the ‘the prisoner’s dilemma’. In this model, two individuals face punishment if either confesses. If we approach this as an economic issue, two competing companies must decide whether to launch big-budget advertising campaigns. Advertising enables a company to take some consumers away from another company. But if both decide to launch campaigns, then the effect on demand is cancelled, and both companies lose money unnecessarily. Faced by the prospect of two simultaneous campaigns, Rodrik says that we should expect both companies to cancel their advertising plans – but the model shows that the logic is otherwise. When a company considers only its profits, it has an incentive to advertise regardless of what the other company does. When a company does not advertise, the other can take its customers. And when a company does advertise, the other company must also do so, to avoid losing customers. Such a market, unlike the perfectly competitive model described above, is not at all efficient.

However, neither model is right or wrong. Each provides a different view of how the market works (or might work) in the real world. In the words of the author: “A conventional view is that economists are rigid market fundamentalists who believe that the answer to every problem is to let the market operate freely. Many economists may share this belief. However, this is not what economics teaches. The correct answer to almost every question economic is: it depends. Different and equally respectable models provide different answers”. Models do more than just warn us that the results can go in both directions. For example: do minimum salaries increase or decrease employment? The answer depends on whether employers behave competitively or not. That depends on whether they can influence salaries in their local area. Do capital flows into an emerging economy increase or decrease economic growth? The answer depends on whether a country’s growth is restricted by a lack of
investment or low profitability (caused, for example, by high taxes). Does a reduction in a state’s fiscal deficit hinder or stimulate economic activity? The answer depends on that state’s credibility, monetary policy and monetary regime. The answer to all these questions depends on the characteristics of the real-world context.

One of the many jokes that economists tell about themselves is that an economist is someone who sees how the world works in practice – and then wonders if it also works in theory. If you ask an economist if economics is a science, he or she will surely answer that economics is, because it uses the scientific method: hypotheses are built and then tested. When a theory fails the test, it is discarded and replaced with an improved version. In the end, economics improves because it keeps developing theories that explain the world a little better. However, Rodrik says that this is just a nice story – and has little to do with how economists work in reality and how the subject has developed. Models, he says, are usually formulated in response to an observed irregularity, or following the detection of something that current models cannot explain. Even when the deductive approach is followed, in which a hypothesis is tested, much of what is produced by economists is not truly testable. In addition, many economic models offer contradictory conclusions. Therefore, argues Rodrik, progress is more driven by trends, or changes in opinion about the best strategies to develop a model, than the evidence itself.

The key point is that the fluidity of social reality makes economic models difficult, or even impossible, to prove. In economics, context is everything. Knowledge accumulates horizontally rather than vertically, with new models that explain aspects of social outcomes that had not been previously examined. In Rodrik’s opinion, this multiplicity of models is both the strength and weakness of economics. What kind of science has different models for everything? Can a collection of models be called a science? Yes, says Rodrik – but we must remember that models contain information on the specific circumstances under which they are relevant and applicable. This means that in a certain context, we can distinguish which models are useful, and which are not. The multiplicity of models does not mean that anything goes. Identifying the appropriate model requires analysing which model highlights the dominant causal mechanism, which allows us to explain what has happened best, and which has the most potential to predict the consequences of our actions.

The key, says Rodrik, is to switch continually between the possible models and the real world, something he calls ‘verification’. The following strategies need to be followed: 1) Verify the critical assumptions of a model and see how they respond in each context. Failure to do so can cause considerable problems in practice. As noted by the author, this was something economists learnt the hard way in the 1980s and 90s, during the frenzied defence of market liberalisation. During that period, many economists thought that price liberalisation and the removal of market restrictions would suffice to let the market distribute resources efficiently. They forgot, however,
the need for strong institutions to support and police the markets. This led, for example, to the privatisation of state enterprises in the former USSR, which accelerated cronyism rather than creating efficient markets; 2) Verify that the mechanisms of the model work; 3) Verify that the direct implications of a model are confirmed. The growing tendency to perform field experiments with control groups is a move in the right direction and provides more credible results (providing the characteristics of the context sufficiently resemble the model); 4) Verify that the implications are consistent with observed results; and finally; 5) Verify the model’s external validity: although we may believe that a model works under certain circumstances, we need to know whether it is applicable in the real world.

Above all, insists Rodrik, it is crucial to avoid confusing models with ‘the model’. When this happens, two problems can occur. Firstly, errors de omission and the inability to see imminent obstacles. Many economists, for example, failed to see the dangerous confluence of circumstances that triggered the global financial crisis of 2007-08. Many interpreted the crisis as evidence of a fundamental breakdown in the discipline of economics and defended the need to rethink and reshape the economy. However, Rodrik emphasises that the crisis was in fact particularly interesting because many existing models in fact helped explain what had been happening in the economy. Bubbles are not a recent phenomenon. Their presence has been noted since at least the Dutch tulipomania crisis in the seventeenth century, and the English South Sea Company bubble in the eighteenth century. The financial crisis of 2008 showed all the characteristics of a bank panic. And this, too, is a basic economic phenomenon. The models of self-fulfilling panic are known to all economics students – as well as the conditions that facilitate such panics. Another basic feature of the pre-crisis period were the high risks taken by the leaders of financial institutions, which is fully explained in the principal-agent model. Under this model, the ‘principal’ (a regulator, the electorate, or a shareholder) attempts to control the behaviour of an agent (regulated company, elected government, or a CEO) when the latter has more economic information than the former. The resulting difficulties and inefficiencies should not have been a surprise. Finally, the wider economic consequences of the collapse in asset prices were also known to economists, especially after the financial crises experienced by developing nations from the 1980s.

Clearly, economists did not lack models of analysis. Therefore, says Rodrik, economists could have predicted and tackled the crisis. It was clear that the failure was, instead, psychological and sociological. Too much reliance was placed on some models – at the expense of others. This proved to be a major problem. Many of the favoured models, claims Rodrik, revolved around the efficient market hypothesis under which market prices reflect all the information available to investors. The logic of this model is that since all the relevant information is already reflected in the market price, any intervention will distort rather than correct the market. An over-reliance on this model and neglect of other models (such as the ones on bubbles and other financial...
market pathologies) undermined most of the predictions about the market, its role as a machine for social progress, and its efficient, stable, but also self-disciplining character. In the world according to this model, if the big banks and speculators tell lies, then the markets will discover the truth and punish them. Investors who make bad decisions and take inappropriate risks will be shut out, while those who behave responsibly will be rewarded. Meanwhile, governments could not be trusted, because regulators and bureaucrats are either incompetent or ‘captured’ by interest lobbies.

The second problem that can arise when confusing a model for ‘the model’ is an error of commission, in which a fixation on a specific worldview makes economists accomplices in policies whose errors could have been detected before it was too late. For the author, a clear example of this is the support given to financial globalisation and the Washington Consensus. Under this model, the removal of import barriers would mean that companies unable to compete internationally would be reduced in size or bankrupted, so freeing resources (workers, capital, and managers) to work in other areas of the economy. The most efficient and internationally competitive sectors, in contrast, would expand and lead the way to faster economic growth. However, in most African and Latin American nations where this approach was applied, only the first prediction happened and not the second. This was because the markets did not work as expected. The labour markets were not flexible enough to quickly relocate workers to new and more efficient sectors. Capital markets did not support the creation of export-oriented companies. Currencies remained overvalued, and so manufacturing sectors were unable to compete internationally. Governments, lacking financial resources, were unable to invest in the infrastructure necessary to support new industries.

The good news is that most economists have learnt the lesson. The current idea that ‘no set of policies is appropriate for all countries, and internal reforms must be adapted to the local context’ is almost a mantra for development economists, financial experts, and international agencies. The emphasis is now on model selection. However, Rodrik says another problem keeps economists erring today, namely, the fact that most economists see themselves as researchers who write academic papers, rather than experts who foretell events or advocate certain policies. In addition, when economists participate in public discussion, they pepper their arguments with so many ‘if and buts’ that it is difficult to find an attentive audience. Economists who have an audience are usually those with strong convictions, or those willing to ignore the fine print on policy recommendations. Moreover, defending the market in public debates has become almost a professional obligation, and the result is that contributions made by economists in the public sphere can be completely different from their ‘off the record’ remarks. Moreover, economists do not always manage to establish a link between models and the real world. The link may be the result of informal discussions and socialisation processes, rather than the product of analysis, reflection, and observation. All these problems are compounded by the
fact that it is accepted practice for economists to ignore the conditions under which their models may be useful. If they are asked in an abstract sense, many economists can write a whole book chapter on the assumptions necessary to generate a given result. However, if they are asked if that model is more relevant to Bolivia or Thailand, or if it more closely reflects the market for televisions or oranges, then they are likely to struggle to answer.

However, says Rodrik, these deficiencies are not fundamental problems that prevent economists from capturing and responding to social reality. **Economists need to be more flexible, moving between models as circumstances change, and participating in public discussions.** Economists can aspire to be public intellectuals and social reformers, but they must be aware that when adopting this role, they are straying away from the scientific frontiers of their discipline – and they should make this very clear to their audiences. Otherwise, they risk advocating their own value judgments and passing them off as science. **Economists can give us many of the tools necessary to analyse the major problems of our time, but they cannot provide definitive and universal answers.**