

Preface

Until the eruption of the financial crisis in 2007 it looked as if macroeconomics had achieved the pinnacle of scientific success. The industrial world experienced a time of great macroeconomic stability with low and stable inflation, high and sustained economic growth, and low volatility of many economic and financial variables. Economists were debating the causes of this “Great Moderation” and there was a general consensus that at least part of it was due to the new scientific insights provided by modern macroeconomic theory. This theory embodied the rational agent, who continually optimizes his utility using all available information. In this world where individual agents make no systematic mistakes, stability reigns. Sure, there was a recognition that macroeconomic variables could be subjected to large changes, but these changes always found their source outside the world of these rational agents. If left alone the latter, with the help of efficient markets, would produce their wonderful stabilizing work. The macroeconomy was modeled as a world of rationality and supreme understanding that unfortunately was regularly hit by outside disturbances.

It is no exaggeration to state that the financial and economic upheavals following the crash in the U.S. subprime market have undermined this idyllic view of stability created in a world of fully rational and fully informed agents. These upheavals have also strengthened the view of those who have argued that macroeconomics must take into account departures from rationality, in particular, departures from the assumption of rational expectations.

There is a risk, of course, in trying to model departures from rational expectations. The proponents of the paradigm of the fully informed, rational agent have told us that there are millions of different ways one can depart from rationality. There is thus no hope of coming to any meaningful conclusion once we wander into the world of irrationality. This argument has been very powerful. It has been used to discredit any attempt to depart from the paradigm of the rational and fully informed agent. As a result, many academic researchers have been discouraged from departing from the mainstream macroeconomic theory.

The problem with the objection that “everything becomes possible when we move into the territory of irrationality” is that it is based on the view that there is only one possible formulation of what a rational agent is. This is the formulation now found in mainstream macroeconomic models. It is my contention that one can depart from that particular formulation of rationality without having to wander in the dark world of irrationality.

My intention is to show that once we accept the notion that individuals have cognitive limitations, and thus are not capable of understanding the full complexity of the world (as is routinely assumed in the mainstream macroeconomic models), it is possible to develop models based on a different notion of rationality. I also intend to show that this leads to a richer macroeconomic dynamics that comes closer to the observed dynamics of output and inflation than the one produced by the mainstream macroeconomic models.

I will start by presenting the basic behavioral macroeconomic model that embodies the idea that agents experience cognitive limitations. I will use this model to develop a theory of the business cycle, and I will contrast this theory with the one that is obtained from the mainstream rational expectations macroeconomic model. In chapter 2, I present an analysis of how exogenous shocks are transmitted in a behavioral macroeconomic model. This will then lead to an analysis of monetary policies in a behavioral model (chapters 3 and 4). The next two chapters will discuss the extensions to the basic model. One extension is to introduce asset markets in the model (chapter 5); another extension incorporates a richer menu of forecasting rules than the ones used in the basic model (chapter 6). Finally, in chapter 7, I discuss some empirical issues relating to the question of how well the theoretical predictions of the behavioral model perform when confronted with the data.

Clearly, this is not a definitive book. As the reader will find out, in much of the material that will be presented, there are loose ends and unresolved issues. My intention is to explore new ways of thinking about the macroeconomy; ways of thinking that depart from mainstream thinking, which in my opinion has turned out to be unhelpful in understanding why output and inflation fluctuate as they do in the real world.

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