

OTHER THINGS EQUAL

Small Worlds, or, the Preposterousness of Closed Economy Macro

Deirdre McCloskey

University of Iowa

and

Erasmus University of Rotterdam

I was in Denmark for a few days last month to oversee the amazing department of management and philosophy (yes, and philosophy) at the University of Copenhagen. That I was able to make the trip there and back in four days is one obvious testament to a small world. (And this by the way was only my second trip to Europe without jet lag, using the U.S. Army's rapid-deployment technique. You small-worlders need to know the formula. Going West to East, six or seven time zones, in the four days before the flight you eat lots-little-lots-little [the "little" days should be under 900 calories; eat protein, and eat most of your calories in the morning]. No coffee or tea or coke for those days. Then on the evening of the flight—this is the weird part—have two cups of coffee at exactly 6:00 pm Chicago time. Don't eat or watch the movie or do referee reports on the plane. Try to sleep; get ear plugs and eye masks. Next day is a normal day. Believe me, it works.)

Denmark was lovely. I had not slept on the plane, but so effective is the Army's Formula (I have not checked this with the FDA) that I was able to give a reasonably coherent presentation late in the afternoon of my arrival. Well, so it seemed to me (judgment is the first thing to go in jet lag). For the next few days the work gradually transformed into play, culminating in a trip with some girlfriends out to the great collection of modern art at the Louisiana Museum up the Sound from Copenhagen, just past Countess Karen Blixen's house (*Out of Africa*).

If you were from Mars but had had a course in macroeconomics you would be surprised by the following obvious sign of a small world: the price structures in Denmark and the U.S. are basically the same. As I bought gifts at the Museum shop, or walked the Stroget with the same purpose, or saw the home life of my Danish academic friends, I thought: "We live in one price structure, called The World's." I might as well have been in Iowa. Even the intellectual price structures are roughly the same. The last round of fashion in macro persuades only a little less well in Copenhagen than in Cambridge, so swift nowadays is the force of international arbitrage in ideas. I was never startled by a price of clothing or a line of argument.

Why would a Martian with macro be surprised, though I was not? Because she (on Mars most of the economists are women, and it's much more sensibly done) would expect each country to have a separate economy, with each country's own price level

undisciplined by international arbitrage and its own real interest rate. As an economist-in-training the Martian would have come to believe what only economists believe: that if you know the interest rate in a country you know a great deal about its structure of production and of prices. After that true bit of learning she would have learned the false bit: that macroeconomies behave country-by-country; that you can essentially ignore the rest of the world, or treat it as a tiny sector. In the false learning there is a British interest rate and an American price level. Marshall claimed that the gold standard worked by way of Lombard-Street loans for British funds and Friedman claims that the Fed has power over American inflation and Lucas claims that expectations of only Americans matter for American prices and interest rates. In such worlds it would be remarkable if the price of a coffee in the cafe overlooking a rainy King's New Square were roughly the same relative to the price of the artificial tulips at the Magasin du Nord as they would be in Iowa City. But they are.

My point is that this and other elementary observations are scientific evidence that closed-economy macroeconomics is preposterous. We live in a single world, close enough for most scientific purposes. Prices and interest rates are determined by arbitrage at given exchange rates (the one degree of freedom), not by the macroeconomics of individual countries.

What? You object that non-traded goods, half of national income, make for different worlds? May I suggest that you would have to disbelieve the great economic principle of substitutability for the objection to matter. Tastes and technologies fix relative prices. Given this peg, the money prices move in response to world aggregate demand, world money supply, world expectations, world whatever-it-is.

Scandinavian economists earlier in this century understood the point perfectly well, as economists in Britain and the United States at the time did not. All the Swedes did, and wrote books about it: Wicksell, Cassel, Heckscher, Ohlin. There is an amazing debate in the *Quarterly Journal of Economics* in 1918 between Knut Wicksell (Sweden) and Frank Taussig (U.S.) on precisely these lines. The Scandinavian says, It's silly to think of an economy as uninvolved in the world. The American replies, Uh, duh, I don't get it. After the Second World War it was Canadians such as Robert Mundell and Harry Johnson who made the point, and again it was Americans who didn't get it and kept running models of single national economies without an international context.

What? You object that this exogeneity of prices and interest rates to any one economy is a "small open economy assumption" and would not be true of a country like the U.S. big enough to affect world prices and interest rates? May I suggest that you are confusing a big percentage (30 percent say) with 100 percent, and that the price theory of the two is different?

What I am saying is that for most purposes Denmark is no more separate from the American economy than Maine is from the economy of California. If you proposed to do a macroeconomic study of the economy of Maine without recognizing that Maine faces given prices and interest rates from the larger American (and I say World) economy of which it is a part, people would laugh. I'm afraid that is my reaction to the frequent move in macroeconomics to do the same for some country, even the United

States, in a World economy. It is impolite, and I wish I could be more graceful, but when some macroeconomist says, "Posit the following [implicitly closed and anyway autonomous] economy" I want to giggle. I think of saying, and too often actually say, Don't you realize, dear, that markets in wheat, iron, and professors of economics constrain the macroeconomics of the U.S. the same way that Maine (or if you wish California) is constrained? My inability to control my mirth explains why I don't go to many seminars in macroeconomics. (The reason I don't go to many in micro is comparably simple: I lost patience about a dozen years ago with the turn, "Assume the following setting [with no evidence that the setting occurs approximately in the world].") In neither case does any science appear to be happening. So I go to seminars in law, biology, physics, and economic history.)

I regard what I have just said about macroeconomics in one country as obvious. I admit that most economists will not understand it, or see its devastating force in undermining the program of modern macroeconomics. I'm accustomed to people not grasping points I make, and becoming indignant at my presumption, a mere economic historian (= economic scientist), to cast doubt on the routine of Barro or Sargent or whoever they think has macroeconomics just right this year.

My own theory of why the world context for macromodeling has been overlooked (I know you'll point to the subfield of open-economy macro; to which I reply that there shouldn't be any other kind) is that economics has become self-referential, the way math or philosophy are. Or the way modern academic art or modern academic music or modern academic poetry are. I went to a reading by Jory Graham a couple of weeks ago in Iowa City, and could see that she was writing to other professors of poetry. A week later I heard Norman Mailer in town. Whatever your opinion of him it's clear that he writes for people, not professors. Anyway, modern economics is not about the economy. It is about What Bob Thinks (supply your own Bob). Styles of modeling go in and out of fashion because Bob Says So, not because some low-status Cecilia Payne-Gaposchkin has come from the equivalent of observatory or archive or laboratory with a new fact. Country-by-country macroeconomics makes as little sense as star-by-star galactic mechanics would. That the next article you read in macro is likely to ignore the gravity of the surrounding world illustrates how much we in economics work model-to-model instead of model-to-world or world-to-model.

But you've heard my complaint on this score. What's new here is my complaint about a substantive assumption that most modern macroeconomics makes and that is obviously preposterous. Actually the point is not new, not in any sense. For one thing, as I said, the argument is old in the history of economic thought, especially from economists born in places like Canada or Sweden in which it was obviously preposterous to claim economic autonomy from the United States or the German Empire.

For another thing the "new" integration of the world economy is quite old, centuries old in fact. By some standards world economic integration was achieved by the 18th century. And no surprise. If that principle of substitution I mentioned is even weakly influential it would not take many strands of trade in tobacco and sugar and fine furniture and printers to tie Virginia firmly to Britain in 1770. The scientific

question is "the standard." How big is big? How close do economies have to be tied before it become preposterous to suppose that one exists independent of the other? The answer is a quantitative and human judgment, not to be handed over to statistical significance. I'd compare it to the few impressionist paintings I saw in the Louisiana Museum. Stand too close to them and they are a mangle of brushstrokes; stand too far away and you can't make them out; stand just right and you gather the impression, say, of a Danish evening in late spring. That's the empirical work that needs to be done to bring macroeconomics back to the world. Meanwhile the stuff written, as Larry Summers agrees, is like the bulk of the art in the Museum—abstract, academic, self-referential, not about the world but about the theoretical imagination of the artist. It's amusing, a fun game. But it ain't science, or even much of an art.

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