A pioneer of modern economics passes away

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Robert Lucas Jr, a pioneer in modern macroeconomics and economic growth, passed away recently at the age of 85. The news brought back the memory of a morning in January 1996, when I was in San Francisco as part of a large crowd of PhD students from various US universities gathering for the annual American Economic Association meeting for the academic job market: As I walked into the hotel room for my University of Chicago job interview, I was greeted at the door by Robert Lucas, who had won the Nobel Prize just a few months ago. A handsome, charismatic man with greying hair, a genial smile and a twinkle in his eye, he looked quite different from the mental image I had, based on photographs that highlighted an intense and no-nonsense gaze, of the fierce and fearsome warrior of the macro wars of the 1970s between Keynesians and the New Classical School.

Professor Robert E Lucas (L) from the University of Chicago receives the Nobel economics prize from Swedens King Carl XVI Gustaf during the Nobel Prize ceremony in Stockholm Concert hall December 10 (Reuters)

Lucas is most famous for his work on rational expectations. When he started working in this area, traditional macroeconomics was dominated by the debate between Monetarists and Keynesians. They differed on the primacy of monetary and fiscal policy in regulating the macroeconomy as well as on the role played by the supply-side of the economy versus the demand side. The Keynesian view emphasized how lack of aggregate demand causes unemployment and expansionary policies can help boost income and employment. The monetarist view, led by Milton Friedman of Chicago, arose out of the dangers of inflation that expansionary fiscal policies could create and gained increasing currency as Western economies began to grapple with the problem of stagflation. Lucas and the New Classical school built on the work of Monetarists, but their key contribution was methodological, focusing on how economic agents form expectations about the future in choosing current actions. In contrast with earlier approaches that treated expectations mechanically -- assuming that people simply use a weighted average of what has happened in the recent past -- they proposed that individuals use all the information they have about the state of the economy and government policy to form their expectations, which are “rational” in the sense that people cannot be systematically fooled.

The Philips curve, a stylized macro empirical fact that suggests inflation and unemployment have a negative relationship, seemingly posed a policy trade-off – expansionary policies would reduce unemployment but at the expense of inflation. Lucas and other researchers such as Thomas Sargent and Neil Wallace demonstrated that if people form their expectations rationally, then this trade-off can only exist temporarily -- people will adjust their expectations about inflation anticipating that nothing real will change if all prices and wages rise, and therefore, will not be “fooled” into expanding real economic activity. Thus, they argued, in the long-run there is no inflation-unemployment trade-off -- the unemployment rate would gravitate to it natural rate while the rate of inflation could vary.

Lucas went on to extend this idea in many interesting directions. One particularly influential contribution had to do with how economists model the effect of government policy. The existing approach took the behaviour of economic agents as given: the policymaker changes policy with the premise that people passively react to policy. Lucas pointed out that if agents change their behaviour in response to policy, that should be factored in when evaluating economic policy. Rather than assuming the policymaker is shooting at a fixed target, one has to allow for the fact that the target will move in response to the actions of the policymaker and may have every incentive to act in ways that would invalidate the intended goals of the policy. Even though developed in a macroeconomic context, this is a profound insight that applies to any policy and adds a fundamental constraint to policy effectiveness.

From the point of view of modern economic theory, none of this is particularly controversial. Following the Game Theory revolution, it is now standard to allow the behaviour of economic agents to be consistent with each other’s so that no one can profitably deviate. In the war between the rival macro camps, the debate has shifted, especially since the financial crisis, to frictions or rigidities in the real economy (say, due to informational constraints or search costs in specific markets). In that case, even with such rational behaviour there can be inefficiencies in the economy that policy can be effectively deployed to alleviate. Of course, these policy debates had a political aspect to it, with the Keynesian camp being more on the left-of-centre of the policyspace in the sense of being favourable to government intervention, while the Chicago-view was more to the right, libertarian end.

However, from Lucas' biographical accounts and interviews, and my own personal interactions with him, my impression is that, while he was certainly sceptical about the role of government policy, he was no conventional right-winger. He often mentioned that he was influenced by Marx in putting economic forces at the heart of how we understand the world. Moreover, he grew up in an intellectually vibrant family environment that was solidly on the progressive side. Even though his policy-leanings put him more often on the conservative side, his social views were progressive, and he reportedly voted for Barack Obama in 2008. In my own work in the area of Development economics, one of the classic papers is Lucas' 1988 paper "On the Mechanics of Economic Development" where he makes an eloquent case that studying the problems of underdevelopment has profound implications for human welfare, second to nothing else.

The profession will remember Robert Lucas as a truly great economist of the modern era. To me, he was a restless, fiercely intellectual scholar who brought in rigour and profound insights into any problem he studied, stayed active in research till the very end, and acted as a mentor to a complete greenhorn like me (and to many others), whose work and policy-orientation were very different from his, with warmth and grace.