Confronting Economic Uncertainty

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SAIF-CAFR
Distinguished Speaker Series
Probability meets Social Science

Jacob Bernoulli (left)

*Law of Large Numbers*: how unknown probabilities are revealed (1713)
Dual Roles for Statistics in Economic Analysis

▷ Outside a model
  Given a dynamic economic model, researchers:
  • estimate unknown parameters
  • assess model implications

▷ Inside a model
  When constructing a dynamic economic model, researchers:
  • depict economic actors (consumers, enterprises) as they cope with uncertainty
  • deduce the consequences for market outcomes, resource allocations and economic policy
Multiple Components to Uncertainty

• **Risk**
  uncertainty *within* a model: uncertain *outcomes* with known probabilities?

• **Ambiguity**
  uncertainty *over* models: unknown *weights* for alternative possible models?

• **Misspecification**
  uncertainty *about* models: unknown *flaws* of approximating models
Uncertainty and Skepticism

The Cheat, Georges de La Tour
Statistical Complexity

▷ When is it challenging to learn and draw inferences?
▷ When is there more scope for behavioral distortions?
▷ When does statistical uncertainty induce fluctuations in market prices and impact resource allocation?

Take a broader perspective on uncertainty than is typical in economic analyses.
Uncertainty Can Be Complex

Las Meninas, Diego Velázquez
Long-term Uncertainty

Joel Mokyr
“There are a myriad of reasons why the future should bring more technological progress than ever before – perhaps the most important being that technological innovation itself creates questions and problems that need to be fixed through further technological progress.” (2013)

Robert Gordon
“…the rise and fall of growth are inevitable when we recognize that progress occurs more rapidly in some time periods than others…The 1870-1970 century was unique: Many of these inventions could only happen once, and others reached natural limits.” (2016)
Evidence from Macroeconomic Data

![Graph showing China GDP growth and industrial production growth over time](image)
Rational Expectations Inside an Economic Model

Muth (1961) and Lucas (1972): Economic actors (investors) use long histories of data to infer the model, including its parameters.

▷ Yields a stochastic notion of equilibrium with expectations determined inside the model
▷ Gives a coherent approach to policy analysis

Influential in academic research, but neglects some components of uncertainty by featuring only risk. Statistical challenges are off the table.
Risk Inside the Model

▷ Recent empirical successes in macro-finance modeling rely on investors with knowledge of potentially statistically subtle components of the macro time series. Where does this confidence come from?
▷ Imposes stochastic volatility exogenously.
▷ Imposes large risk aversion.

Success?
Navigating Uncertainty

Statistical models we use in practice are misspecified, and there is ambiguity as to which among multiple models is the best one.

- **Aim of robust approaches:**
  - Use models in sensible ways rather than discard them.
  - Provide tools for limiting the type and amount of uncertainty.

- **Uncertainty aversion**

- **Outcome** - Target the uncertainty the most adverse consequences.
Uncertainty and Financial Markets

Bear Bull Rumble, Adrian deRooy
Evidence from Financial Market Data

Private sector observation: risk-on risk-off
• Investors’ appetites for risk rise and fall over time

Academic research: time-varying risk premia
• Measured risk-return tradeoffs from financial markets fluctuate over time

What explains these movements?
Market Adjustments for Uncertainty

Suppose the private sector is uncertain about future macroeconomic growth rates

▷ Investors fear persistence in bad times and fear the lack of persistence in good times
▷ Induces fluctuations in market prices of uncertainty
Market Adjustments for Uncertainty

Graph showing Economic Growth against Horizons (Quarters).

- Economic Growth on the y-axis ranges from -5 to 25.
- Horizons (Quarters) on the x-axis ranges from 0 to 40.

The shaded area indicates an upward trend with increasing horizons.
Market Adjustments for Uncertainty
Friedrich Hayek (1974)

“Even if true scientists should recognize the limits of studying human behaviour, as long as the public has expectations, there will be people who *pretend* or *believe* that they can do more to meet popular demand than what is really in their power.”

(From Hayek’s Nobel address)
Climate Uncertainty

“Global efforts to mitigate climate change are guided by projections of future temperatures. But the eventual equilibrium global mean temperature associated with a given stabilization level of atmospheric greenhouse gas concentrations remains uncertain, complicating the setting of stabilization targets to avoid potentially dangerous levels of global warming.” (2009)

M. R. Allen et al.
Uncertainty and Climate Change Policy

“Any serious discussion of the changing climate must begin by acknowledging not only the scientific certainties but also the uncertainties, especially in projecting the future. Recognizing those limits, rather than ignoring them, will lead to a more sober and ultimately more productive discussion of climate change and climate policies.”

Steven E. Koonin (2014, former undersecretary for science in the US Department of Energy)
Uncertainty and Financial Market Oversight

- **United States**: Financial Stability Oversight Council (created in 2010)
- **China**: Financial Stability and Development Committee (created in 2017)

**Challenges:**

- **What is systemic risk?**: A grab bag of scenarios rationalizing interventions in financial markets
- **Better to view as systemic uncertainty**: Limited understanding of systemic risk challenges its value as a guiding principle for financial oversight
Do Complicated Problems Require Complicated Solutions?

Financial market oversight is arguably a complicated problem

▷ Acknowledge limits to our understanding of the linkages between financial markets and the macroeconomy.
▷ Specific models could imply alternative complex solutions.
▷ “Robust” policies perform well across alternative models.
▷ Simple robust policies avoid adding uncertainty to the economic environment.
When you know a thing, hold that you know it; and when you do not know a thing, allow that you do not know it - this is wisdom.

- 孔子 (Confucius)
Education is the path from cocky ignorance to miserable uncertainty

- Mark Twain