Preface

When in the early 1970s I decided to study econometrics as an elective in my undergraduate economics degree, I was asked if I could invert a matrix. When I proved that I could do that, I was allowed to be one of the few (those who could, amongst other things, invert a matrix) to study econometrics as an elective. How things have changed since that time, as econometrics has become a necessity for those studying economics, surpassing in terms of importance economic statistics, history of economic thought, economic history and applied economics. Econometrics has since changed from a means to become an end by itself, to the extent that I know of at least one major university that has a Department of Econometrics. We have reached a stage where we are expected to have more faith in the results of econometric estimation and testing than theory, intuition and common sense. This cannot be a positive development for the study of the “dismal science”.

When I started my econometrics classes, I was told that econometrics consisted of three elements: economic theory, mathematics and statistics – economic theory came first. Since then, economic theory has paled into insignificance as emphasis shifted to the development of econometric methods and pure mathematical abstraction. Econometric methods are described as statistical methods developed to deal with economic data, which may sound plausible but the problem is that statistical methods are designed to analyse experimental data. Econometricians, however, believe that they are capable of devising econometric methods that can deal with the problems associated with historical economic and financial data, including errors of measurement and unobservable variables. This is an illusion or wishful thinking.

When I was in investment banking for ten years I used my knowledge of econometrics twice. On the first occasion, I ran a simple OLS regression to explain variations in the dollar’s effective exchange rate in terms of the interest rate and growth, hoping to find an explanation for the extraordinary strength of the US currency in the first half of the 1980s. On the second occasion, I ran a series of OLS regressions to reveal the exchange rate regime followed by a particular country, with the objective of taking advantage of arbitrage opportunities. In both cases the results
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turned out to be useful, and in both cases the exercise involved no more than running simple regressions and reporting the results (in English, not econometrics) to senior management. However, I recall conducting a study whose results were subsequently used to design a profitable trading strategy. That study was based on correlation analysis, which is simple statistics, not econometrics.

When I took the heroic decision to join academia in the early 1990s, I had to take econometrics seriously, both in my teaching and research. With the passage of time, I became increasingly sceptical of the usefulness of econometrics until I realized that reality was far away from what econometricians had led us to believe. I realized that progress in the development of econometric methods was disproportional to our understanding of the working of the economy and financial markets. More seriously, I became increasingly convinced that econometrics provided the means of producing results that support prior beliefs. Eventually, I reached a stage when I started to believe that the rise of econometrics to prominence has been detrimental to the progress of economics. As a result, I have decided to write this book to expose the limitations and abuses of econometrics and to demonstrate that it is a con art that can be used to prove almost anything.

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To Nisreen, Danny and Ryan