

# ECONOMICS IN CRISIS?

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“If economists wished to study the horse, they wouldn’t go and look at the horses. They’d sit in their studies and say to themselves, “What would I do if I were a horse?”

—Ely Devons”

from

Mark Buchanan (2010) *“Forecast: What Physics, Meteorology and Natural Sciences Can Teach Us About Economics”*

# Outline

- What is mainstream economics?
- What distinguishes mainstream and heterodox?
- A Brief History of Student Movement
- Mainstream's Response
- A Critical Assessment

# Mainstream economics

- Sometimes called “neoclassical economics”
- A distinct methodological approach to analyze economic phenomena.
- The starting point is the individual agent or the firm
- Individual's decisions on consumption, saving, labour supply etc.
- Firm's decision on investment, wages, labour demand
- A bottom-up approach where individual's and firm's decisions are aggregated, or a representative individual/firm is used for the analysis.

# Mainstream Economics

- Varoufakis (2010) identifies this approach as “Methodological Individualism”
- In its strictest form, “All explanations are to be synthesised from separate, autonomous, and prior explanations at the level of the individual.”
- *“A strict explanatory separation of structure from agency is imposed, with an analytical trajectory that moves unidirectionally from full explanations of agency to derivative theories of structure”*

# Mainstream Economics

- Different versions of mainstream have evolved through time
- Monetarism of Friedman
- Real Business Cycle Theory with voluntary unemployment as the individual's choice of leisure over work
- New Keynesian Macroeconomics (Dynamic Stochastic General Equilibrium) where unemployment is a result of wage rigidity (particularly downwards), asymmetric information, or search & matching imperfections

# Mainstream Economics

- Society, institutions, social norms, classes or power relations have no role in such an analysis.
- Without imperfections and frictions, an unregulated market (with perfectly flexible prices and perfectly informed individuals) would give optimal ('Pareto efficient') outcomes
- This belief constitutes the central reference point for economic analysis and policy evaluation
- Policymakers should strive to replicate the outcomes that would have prevailed under this optimal setting.

# Mainstream Economics

- Strong insistence on equilibrium, or equilibrating forces (methodological equilibration)
- Crisis seen as the result of “exogenous” shocks rather than the outcome of endogenous forces
- Explaining the reason of the “shock” is not the task of the mainstream models
- Economies converge to their “inescapable” long run equilibrium values following these shocks

# Mainstream Economics

- Insistence on formal analysis and a strictly instrumentalist approach to mathematical modelling.
- Realisticness of assumptions does not matter, the only relevant criterion to asses the scientificness of a theory is its predictive power (by which mainstream economics is the ultimate failure)
- At the extreme, Friedman claimed that the more unrealistic a model's assumptions are, the better the model is.

# Mainstream Economics

- “The models [in economics] are all wrong. Many people have emphasized that point... That's what makes economics different. These things are all invalid, but we work with wrong models because they are simple, and – of course – because they are useful.”

Stephen Williamson, DSGE modeller

- Mainstream economists do not consider any other approach with a different methodology as economics
- Institutionally backed up by journal ratings, which direct academic hiring decisions and allocation of research funds

# Lavoie (2014)

*Table 1.3 Presuppositions of the heterodox and orthodox research programmes*

Presupposition	Heterodox schools	Orthodox schools
Epistemology/Ontology	Realism	Instrumentalism
Rationality	Environment-consistent rationality, satisficing agent	Hyper model-consistent rationality, optimizing agent
Method	Holism, organicism	Individualism, atomicism
Economic core	Production, growth, abundance	Exchange, allocation, scarcity
Political core	Regulated markets	Unfettered markets

# Economics Education

- Economics education across the world heavily dominated by mainstream (neoclassical) approach.
- Although mainstream economics can span a wide range of political views, textbooks are particularly populated with neo-liberal policy recommendations.
- Wage reduction as a solution to unemployment, ineffective fiscal policy, anti-minimum wage regulations, anti labour-union, marginal productivity theory of wages and profits
- No mention of alternative schools of thought such as Post-Keynesians, Marxists, Austrians, Feminists in textbooks
- Most universities removed even “History of Economic Thought” from their curriculums

# Student Movement: A Brief History

- A long history of opposition to the teaching of economics, dating back to 1970s.
- June 2000: A petition by economics students in Paris leading to the foundation of Post Autistic Economics
- *“Most of us have chosen to study economics so as to acquire a deep understanding of the economic phenomena with which the citizens of today are confronted. But the teaching that is offered, that is to say for the most part neoclassical theory or approaches derived from it, does not generally answer this expectation.”*

# **Student movement**

- However, the movement gradually faded away, particularly due to the macroeconomic tranquillity during the long boom years between 2002 – 2008.
- Mainstream economics declared its victory over economic policy in this period, celebrated also by central banks and international institutions such as the IMF, World Bank, etc.
- The critics were accused of being stuck in outdated theories, not grasping the new economic order.

# Student movement

- “(D)evelopment of financial products, such as asset-backed securities, collateral loan obligations, and credit default swaps, that facilitate the dispersion of risk” “..These increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system than the one that existed just a quarter-century ago.”

Alan Greenspan, FED Chairman (2005)

# **Student movement**

- A complete turn of events following the 2008 crash and the long recession that followed.
- No warning of a crisis that threatened the integrity of capitalism itself by mainstream economists. This is mainly because there is no significance of debt relations, no asset price bubbles and speculation, and no real monetary economies in mainstream economics.
- Public anger against excessively high financial sector salaries, bank bail-outs, cuts in social spending.

# **Student movement**

- Emergence of popular social movements such as “Occupy” following the crisis.
- Further, a group of heterodox economists had been warning of a forthcoming crisis since 2006 (Bezemer 2009)

*Table 1: Anticipations of the Housing Crisis and Recession*

Analyst	Capacity	Forecast
Dean Baker, US	co-director, Center for Economic and Policy Research	"...plunging housing investment will likely push the economy into recession." (2006)
Wynne Godley, US	Distinguished Scholar, Levy Economics Institute of Bard College	"The small slowdown in the rate at which US household debt levels are rising resulting from the house price decline, will immediately lead to a ...sustained growth recession ... before 2010". (2006). "Unemployment [will] start to rise significantly and does not come down again." (2007)
Michael Hudson, US	professor, University of Missouri	"Debt deflation will shrink the "real" economy, drive down real wages, and push our debt-ridden economy into Japan-style stagnation or worse." (2006)
Stephen Keen, Australia	associate professor, University of Western Sydney	"Long before we manage to reverse the current rise in debt, the economy will be in a recession. On current data, we may already be in one." (2006)
Robert Shiller , US	professor, Yale University	"There is significant risk of a very bad period, with rising default and foreclosures, serious trouble in financial markets, and a possible recession sooner than most of us expected." (2006)
Nouriel Roubini, US	professor, New York University	"Real home prices are likely to fall at least 30% over the next 3 years"(2005). "By itself this house price slump is enough to trigger a US recession." (2006)

# Student Movement

- Popularization of heterodox thinkers such as Minsky, Marx, Hayek in the post-crisis period
- A revival of the student movement in this context
  - ✓ PEPS Economie in France in 2009
  - ✓ Rethinking Economics set as a reading group at University of Tübingen in 2010
  - ✓ Network for Plural Economics (Netzwerk Plurale Ökonomik) as a collaboration of fourteen student societies, academics and researchers in Germany
  - ✓ Mankiw student walkout at Harvard in November 2011

# Student movement

- Post-Crash Economics Society (PCES) at University of Manchester founded in early 2013
- Campaigning for a pluralist economics curriculum and demanding a more real-world oriented economics teaching/modules on heterodox economics
- Public lectures on Post-Keynesian, Marxist, Austrian, Ecological, Feminist, Institutionalist Economics
- A comprehensive critical report on the economics curriculum at University of Manchester

# **Student movement**

- Non-credit evening lectures on heterodox economics and history of financial crises (Bubbles, Panics and Crashes)
- Impressively successful in popularizing the discussion on teaching of economics
- Excessive media coverage in The Guardian, Independent, The Economist, Wall Street Journal Blog, New York Times etc.
- PCES's success led to the emergence of similar societies in the UK, as well as a global organization of autonomous student societies all over the world

- ◎ May 2014: International Student Initiative for Pluralism in Economics (ISIPE),

# INTERNATIONAL STUDENT INITIATIVE FOR PLURALISM IN ECONOMICS

ARGENTINA - AUSTRALIA - AUSTRIA - BRAZIL - CANADA - CHILE - DENMARK - FRANCE - GERMANY - INDIA - ISRAEL - ITALY - PAKISTAN - RUSSIA - SLOVENIA - SPAIN - SWEDEN - SWITZERLAND - UNITED KINGDOM - USA - URUGUAY

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We are a collaboration of 65 associations of economics students from 30 countries around the world.

Pluralism is our motto. We want to bring about a more open, diverse and pluralist economics.

# **Student movement**

- Rethinking Economics conference series, initially organized by students at University of Tübingen, evolved into a global central network of students, academics, and civil society groups campaigning for a reformulation of economics science and its teaching
- Two large conferences in London and New York in September 2014
- Kingston University Re-thinking Economics group launched last week by a public lecture by Prof. Steve Keen

# Mainstream's Response

- Initial promising developments, particularly in the UK.
- A discussion group mainly consisting of mainstream economists following a Bank of England conference in 2012 entitled “Are Economics Graduates Fit for Purpose?”
  - ✓ Students should be given a higher awareness of economic history and limitations of mainstream economics’ methodology
  - ✓ Need for a greater degree of pluralism, and to confront all theoretical frameworks with empirical evidence

# Mainstream's Response

- However, the group asserted (a completely ungrounded) superiority of mainstream economics over heterodox alternatives.
- “Pluralism should not be confused with the heterodox approach” (Coyle 2013)
- Deficiencies in economics teaching arising from the inability of mainstream economists to incorporate the latest developments in research into the curriculum

# Mainstream's Response

- CORE Project (Curriculum Open-access Resources in Economics): The first serious institutional attempt to reform economics education, financed by INET and led by Wendy Carlin of UCL.
- A re-presentation of mainstream economics blended with some history and recent “favourable” data
- No mention of any heterodox ideas apart from a few funny boxes on Marx, Hayek, Coase and a few other heterodox thinkers
- Complete ignorance of the developments in heterodox economics in the last decades

# Mainstream's Response

- University departments remain resistant to change in the curriculum
- Mainstream economists defend the academic and pedagogical hegemony of their paradigm despite mounting counter evidence
- Coyle (2013): “The basic building blocks of the subject remain solid”

# **A Hypothetical Conversation Between a Mainstream and a Heterodox Economist**

- H - Your models are wrong, they don't describe reality
- M- I know, they don't have to. The instruments can be wrong, the outcome of the model is important
- H -Ok then, I will use different instruments for modelling.
- M - No, you cannot do that.
- H - Why?
- M - Because your instruments are wrong. And they are more wrong than mine.
- H - But you said they can be wrong. So is there also a limit to how wrong they can be? Who decides on that and how?

- M -It doesn't matter what I said before. My wrong ones are the correct wrong ones.
- H - How do you know that?
- M -Because my models have predictive power. And mine also approximate more complex relations very well.
- H - They don't. Almost no mainstream model could foresee the last crisis or many others. There's also plenty of evidence against representative agent/firm modelling, against equilibrium convergence etc.
- M – That does not matter. Mine are the only correct wrong instruments. I just haven't been able to combine them in the right way up to now.
- H - How do you know that?

- M - I know.
- H - Hmm, I have difficulty in accepting that. Can I do economics without instruments may be?
- M - No, you cannot. You have to use instruments.
- H - Why? I am not even sure if we can find the correct wrong instruments. I am a bit sceptical about this.
- M - No, you must use instruments. I know they exist and we can find them. And you don't have to try to find new ones, I have already found some for you. Although I almost never get things right and there's plenty of theoretical and empirical evidence against them, I am sure my instruments are the only correct wrong instruments, and you should use them.

# Central Banks and Students: An Unexpected Alliance

- Bank of England's Andrew Haldane, who wrote the foreword to PCES's report: "It is time to rethink the basic building blocks of economics"
- Claudio Borio (2013) of the BIS : Business cycles should be understood as the result of "endogenous forces that perpetuate irregular cycles in the economy" and "...this will require us to move away from the heavy focus on equilibrium concepts and methods to analyse business fluctuations and to rediscover the merits of disequilibrium analysis".
- Ex-Bank of England Monetary Policy Committee member William Buitier (2009): Most of academic monetary economics since 1970s intellectual sunk capital motivated by internal consistency and mathematical elegance rather than a genuine desire to grasp the working of the economy.

# A Short Assessment

- Impressive achievement in popularizing the discussion on economics education, and organizing autonomous groups
- But the movement has not yet managed to convince the university managements to a meaningful reform
- Popular social movements such as Occupy and the student movement feed from similar dynamics
- However, unlike Occupy, the student movement could organize around a set of common goals despite political disparities among its members

- The student movement invigorated heterodox economists
- Heterodox economists should maintain support and develop a new set of teaching tools
- Student groups should not forget the relationship between the dominance of mainstream economics and the neo-liberal political and social agenda
- They should seek alliance with broader social groups (such as trade unions) to increase the possibility of success

# Koch brothers sought say in academic hiring in return for university donation

- Florida university receives \$1.5m from rightwing billionaires
- Kochs wanted appointment of ultra-rightwing economics faculty

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