

## HOW TO RECOGNIZE NEW ECONOMIC THINKING

*By William Janeway*

The Global Financial Crisis of 2008 and the Great Recession that followed challenged much conventional wisdom and academic orthodoxy with respect both to theory and policy. New economic thinking was needed and that need has been extended and amplified through the succeeding years.

But: what constitutes “new economic thinking?”

Four pillars of “new economic thinking” are ready to hand as markers:

- Recognition that economic and financial decisions are necessarily made under varying degrees of uncertainty with respect both to their direct consequences and, more broadly, to the future environment in which those consequences will be realized.
- Explicit effort to (re)integrate economic and financial studies – both theoretical and empirical - all the way up and down the structural hierarchy of society.
- Reinstatement of the distribution of income and wealth as core subjects of economic and financial analysis.
- Taking history seriously: “thick” history that reaches beyond quantitative data to take account of the evolution of the social and political and cultural contexts which condition economic and financial experience.
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### **Decision-making Under Uncertainty:**

Microeconomics today encompasses a range of creative approaches to capturing the way human beings actually make decisions. In addition to the [Prospect Theory of behavioral economics](#), these include a variety of alternative approaches that acknowledge the ontologically inescapable limits on human knowledge, escaping from the caricature of the perfectly rational, omniscient economic agent. Continuing work incorporates the influence of inherited institutions and the overlapping networks individuals inhabit. One measure of achievement in these efforts may be acceptance that “rationality” is not a binary variable but is context-specific: the same behavior by the same agent may be rational or irrational under different conditions.

A central challenge remains: to analyze the coordination failures that arise from the interactions among imperfectly knowledgeable individuals motivated by more and other than quantifiable gain. This necessarily means challenging the simplistic pursuit of “consistent” integration from rigorously unrealistic microfoundations to manifestly inaccurate macroeconomics. It has been said that it would be more fruitful to work back from the observable patterns of macroeconomic behavior – including booms and busts, bubbles and crashes – to the microeconomic foundations that could generate such outcomes, rather than to simplify the microfoundations to such an extent that only exogenous shocks could generate deviations from full employment equilibrium. Even the realistic “frictions” of New Keynesian models are presumed to be unfortunate imperfections rather than the expression of essential human propensities.

A related dimension offers another marker for new economic thinking. Mainstream economics since [Alfred Marshall](#) and especially [Arthur Cecil Pigou](#) has recognized that externalities generated by even the most rational of economic actors can legitimize state interventions in response to market failures. But such state interventions are themselves also embedded in the structures of ideology and power that emerge and rationalize economic and financial relationships. They are neither automatic, technical consequences of market failures nor the exogenous corrective actions of an omniscient “social planner.”

As [Karl Polanyi](#) well understood, the overlapping but differing distributions of market and political power live in symbiotic tension with each other, generating occasions for conflict and opportunities for reciprocal rent-seeking. The fear that those with access to political power would use it to redistribute economic and financial resources has been met by the ability of those with market power to purchase political influence and even control. New economic thinking, that is to say, reaches beyond the formulae of neoclassical welfare economics to address the multi-dimensional matrix in which market participants and their decisions are embedded.

### **Integrating Economics and Finance:**

Post-2008, the most obvious absurdity of the [Dynamic stochastic general equilibrium \(DSGE\) models](#) that dominated modern macroeconomics was their exclusion of a financial system. Derived by generalizing from a rational representative agent, such models failed by construction to incorporate capital markets and credit relationships and both lenders and borrowers and buyers and sellers of equities. Macroeconomics, that is to say, abdicated from engaging with the world as it is, a world in which participants in the markets for goods and services also participate in the markets and institutions which enable and intermedicate savers and investors. That this

retreat was accompanied by extreme “financialization” of the economy (measured, for example, by the value of financial assets relative to the operating cash flows of the economy) is more than ironic, for financialization itself was enabled by the divorce of the discipline of finance from economics.

Here the central challenge transcends the addition of financial frictions to DSGE models, an activity that smacks of adding layers of epicycles to a Ptolemaic model of the universe in order to keep the earth at the center. The integration of finance and economics must go all the way down: to the individuals, who continually have the alternative of holding cash among their set of available choices; to the firms, whose executives are continually managing both internally generated cash flows and the changing conditions under which external finance is available; to the various sectors of the economy that differ not only in terms of their productivity, on the supply side, and the price and income elasticities they face on the demand side, but also in terms of their access to capital.

As with the commitment to honoring radical uncertainty, integrating finance and economics increases the difficulty of constructing closed analytical models of economic and financial behavior. The more realistic the assumptions, the harder the math. It is a positive consequence that, together, they invite methodological innovations: not only the use of numerical methods to explore the outcomes of models too complex to solve analytically, but full agent-based simulations, as well. So be it: over the past generation, all of the natural sciences, from physics to chemistry to biology, have found it attractive to adopt simulation techniques in order to explore the complexity of the universe in which we live. Why should economists expect otherwise, when their systems they study are complicated so much more richly by human agency and intention?

### **Bringing Distribution Back In:**

Once upon, a time all economics was divided into three parts: the *allocation* of resources, the *distribution* of income and the *stabilization* of the economy as a whole. Over a long generation, “allocation ate economics.” On the one hand, the Lucasian Critique and the establishment of the Rational Expectations Hypothesis eliminated any role for government in stabilizing an economy destined for general equilibrium by the utility and profit-maximizing actions of its rational market participants whose expectations were informed by a shared model of the world that (happily and necessarily) was presumed to be correct. As for distribution, at the core of the neoclassical production function is the proposition that, in perfectly competitive markets for outputs and inputs, the factors of production receive their marginal products. More or less by stealth, this assertion became operational as both explanation and legitimization of the actual distribution of market rewards: the distribution of income is both definitionally “fair” and, as the logical consequence of a consistent model, no longer a subject of study.

Even before economist Thomas Piketty's demonstration of the power of the Institute-supported book, *Capital in the Twenty-First Century*, whose time has come, the Institute-supported Human Capital and Economic Opportunity research program was generating evidence impossible to square with the neoclassical production function. The historical data made available by Piketty and his collaborators now inform alternative explanations of the evolution of the distribution of income and wealth: the active critique of Piketty's own explanations may prove as valuable to new economic thinking as the data itself.

Bringing distribution back in necessarily requires interaction with the other social sciences. Understanding inequalities in the cross-section and the time series, conditioned on socially constructed categories and socially active networks, brings economists into intimate relationship with those who map those categories and networks and track the behavior of the individuals and groups who belong to them. Explicit retreat from the intellectual imperialism of methodological individualism and rational choice theory as universal solvents is a mark of new economic thinking.

### **Taking History Seriously:**

The reinstatement of distribution is by no means the only pillar of new economic thinking that turns on taking seriously the life histories of individuals and of societies and their components. The marginalization of economic and financial history over the past generation has damaged both disciplines and those who have relied upon them for understanding and guidance. But simplistic attempts to read economic data through flawed economic models is not the way forward. A generation ago, Cliometrics proposed to bring rigor to economic history by embedding historical data in the neoclassical production function, thereby imposing on history the radical counter-factuals that at all times resources are fully employed and optimally allocated. Far from honoring historical experience, it produced a travesty of it.

The complementary mode has been simply to elide from the past that which does not fit: thus, the conventional economic account of the Great Moderation excludes the repeated interventions by central banks and governments to correct the recurrent market crises that populated the years from 1982 to 2007. In finance, the equivalent was to suppose that three years of market data could adequately capture the range of relevant asset price volatility in Value at Risk models. And only willed ignorance of history – plus the excuse of computational convenience – could have allowed the disastrous assumption of a normal distribution of asset price returns and asset price correlations.

At a deeper level, understanding economic and financial dynamics today requires historical exploration of economic development over the past 250 years, as technological innovation enabled escape from the Malthusian trap and shaped the modern world and as simultaneously the forces of creative destruction expressed themselves in the distribution of income and wealth. And this history includes the consequences, positive and negative, of state interventions in markets in pursuit of legitimizing missions, national

development and national security. It also the recurrent financial bubbles that mobilized capital at enormous scale to finance investment in assets of all sorts, some of which – canals and railways, electricity grids and the internet – did, in fact give birth to “new economies.”

Economic and financial history is also the history of the ideas that have emerged from past economic and financial analysis. At the Institute’s [Second Plenary Conference at Bretton Woods](#), the economist and commentator Mark Thoma commented: “New economic thinking means reading old economics books.” Indeed he was right. Recognition that there is much to learn from past efforts to comprehend the dynamics of production and growth, employment and consumption, savings and investment, price discovery and price fixing – and the roles of the state with respect to all – is a marker not only of new economic thinking, but of the maturity of the discipline itself.

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