

## The “Business Cycle” of Economic Ideas

The current economic crisis  
and the role of scientific conformism

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### My main objective

First of all I shall try to shed light again on the methodological issues of some leading economists of the past. The economists I am referring to are:

John M. Keynes  
Milton Friedman  
John K. Galbraith  
Charles P. Kindleberger  
Hyman P. Minsky

Despite the differences – sometimes very strong as in the case of Keynes/Friedman – in their scientific theories, they all share the opinion that individual economic behaviour is characterised by strong limits of knowledge.

On the other hand, it is well known that, over the last twenty years, the economic literature based on individual perfect rationality has prevailed.

The question I try to answer is: how to explain the great split between the cited masters of thought and the very different approach of today based on the Efficiency Market Hypothesis (EMH)?

My particular point of view is focused on the scientific conformism of many economists in the last years, and the conservative academic training of young economists.

### Various types of knowledge are hypothesised by these economists

#### 1 – Keynes

G. A. Akerlof and R. J. Shiller (*Animal Spirits*, 2009) recently pointed out that for J. M. Keynes, economic behaviour can also be driven by non-economic reasons as well as by irrational impulses.

His theories on the way in which businessmen form an opinion regarding the long-term returns of the companies they own or manage, lead to believe that:

Those in whom the speculative mentality prevails, associate profit with a short-term conventional representation of the market conditions (or stock exchange) they operate in;

Those who are instead animated by a genuine entrepreneurial spirit do not have the same possibility of drawing up estimates founded on the expected returns of their companies due to the framework of radical uncertainty in which they operate.

In conclusion, for Keynes the decision-making process regarding investments is “the result of trends of the soul”, in other words, at the mercy of “animal spirits”.

#### 2 – Milton Friedman

For Friedman, the economic subjects show strong limits of knowledge, to the point that a “lack of knowledge” (both in individuals and policy makers alike) can be considered the norm. (See for example, *The Effects of Full Employment Policy on Economic Stability*, 1951, or *The Methodology of Positive Economics*, 1953)

Lack of knowledge is a core issue for explaining Friedman’s “monetary rule”. The monetary policy based on this may (but not necessarily has to) prevent money itself from becoming one of the main causes of economic depression.

The proposition “money matters” therefore has a completely empirical meaning.

In any case, the capacity of “monetary rule” to counterbalance other forces is nevertheless limited. (See *The Role of Monetary Policy*, AER, 1968)

In particular Friedman criticises the opportunistic behaviour of governments: thanks to the monetary expansion they avoid the depression and at the same time avoid increasing the level of taxation, meaning that they maximise consent in the short term. In the long term however, these trends bring about negative effects on the economy.

#### 2 – Milton Friedman (continued)

For Friedman, real markets are not perfect, even though in the long term, they result in being less inefficient than any other method of allocating resources.

In conclusion, the relevance of ignorance of economic subjects leads F. to advance the following evaluations:

a – compared to a short-term analysis, a long-term analysis is more satisfying in terms of reliability of the results;

b – it is more appropriate to think in terms of stability objectives, rather than objectives of any other nature;

c – individuals and governments are not omniscient: an economic policy based on rules and automatism is preferable to one based on discretionary decisions;

d – governments are never benevolent: the impersonal logic of the markets is preferable, even though not perfect, to the “personal” logic of the governing bodies.

## 2 – Milton Friedman (continued)

### Friedman and the New Classical Macroeconomics

The NCM have confirmed the priority given by F. to the market with respect to active economic policy, but they have also produced (contrary to Friedman) a theory of the economy based on the action of individuals allegedly to be perfectly rational and informed.

From this point of view, the NCM have betrayed Friedman and his "economy of ignorance".

## 3 – John K. Galbraith

In *The Great Crash, 1954*, and in *A Short History of Financial Euphoria 1991*, Galbraith provides an analysis of the psychology of human greed.

### Illusions and disillusion

This psychology is marked by the illusions of personal achievement and becoming rich easily during economic upswings (→ speculations → euphoria → bubbles).

And by disillusions of expectations betrayed when one realises that it is not possible to monetise the value of the assets owned, leading to → panic → crash.

The stage of illusions (during the upswing) also involves public authorities who tend to relax their control (as in the case of the revision of the Glass-Steagall Act in 1999).

## 3 – John K. Galbraith (continued)

In short, Galbraith identifies two underlying reasons for the recurrence of crises:

1 – Speculation, considered as an economic effect of a human tendency aimed at circumventing the constraints and difficulties of everyday life: a recurrent temptation of the human spirit;

2 – Economic science seen as the logic (nearly a theology) of the convergence of markets towards equilibrium: the economists fail to grasp the underlying reasons for the financial euphoria since it testifies to a dynamic that is foreign to this logic.

## 4 – Charles Kindleberger

*Manias, Panics and Crashes. A History of Financial Crisis, 1978*

Kindelberger's descriptive investigation focuses on the phase of overtrading which develops as a result of any event capable of raising the hopes of future earnings (displacement).

Kindelberger's three points:

1 – Financial crisis: its roots are found in mass psychology, in other words, in human nature, and also in imperfect institutions (although open to improvement);

2 – Interpretative insufficiency demonstrated by both Keynes and Friedman:  
2.1 – in the case of Keynes, because he does not believe that the psychological consequences of the crisis are greater or more widespread than those triggered by the relationship between S and I mainly considered by him.

## 4 – Charles Kindleberger (continued)

2.2 – in the case of Friedman, because he fails to place sufficient importance on the destabilising speculation or irrational behaviour, and instead places too much importance on the stabilising role of the "monetary rule": "panic cannot heal by itself".

3 – There is a need for an international lender of last resort who, by adopting timely corrective measures, manages to produce the common good of stability.

## 5 – Hyman Minsky

*Can "It" Happen Again? Essays on Instability and Finance, 1982.*

Minsky translates the descriptive and historiographical approaches used by Galbraith and Kindleberger in a theoretical model.

He identifies three types of speculative propensity of the individuals (conservative, speculative, and ultraspeculative), and to each of these he associates different effects on the financial structure of the economy.

In short: the longer the economy experiences an upswing, the more the speculative and ultraspeculative component of the economic operations will increase, in other words, the propensity of the operators to take risks will increase, thereby giving rise to fragility, and ultimately to an unsustainable situation of the financial structure (financial pyramid) → the crash.

### 5 – Hyman Minsky (continued)

#### Notes on the issue of the Keynesian derivation of Minsky's theory

This is similar to the goals pursued by these two economists: to stabilise an intrinsically unstable economy. However there are different reasons they adopt to explain how the phenomenon of instability emerges from the crisis and financial crash.

Minsky's destabilising speculative-financial phenomenon occurs only if and when the phenomenon symbol of the Keynesian crisis is absent, meaning when there is an insufficient level of investments and lack of employment of the resources.

In other terms: the instability analysed by Minsky excludes that of Keynes and vice-versa.

This triggers various types of differences of opinion between the two economists: inflation, a phenomenon of little relevance in the scheme of Keynes, instead becomes very worrying in that of Minsky. The anti-cyclical economic policy exhorted by Keynes finds Minsky sceptical since in the *fine tuning* he sees the origin and spreading of new reasons for speculation and instability.

### A summary of this first part

The five economists considered above have placed great importance on the experiences of individuals and the modus operandi of the institutions in power.

The animal spirits (Keynes), the relevance of ignorance (Friedman), the illusions and disillusion of human greed (Galbraith), the fluctuations of mass psychology (Kindleberger), and the dynamics of speculative tendencies during the economic cycle (Minsky), all represent elements of a contextualised way of theorising and are proof of the cognitive deficits of the economic subjects.

The question that many commentators are asking today is how was it possible to make such a methodological and theoretical jump in economic studies: from the relevance of ignorance in the interpretation of economic process, to the contrary, that is to say the assumption of perfect rationality of economic subjects. And whether this imbalance could just be the cause of the incapacity of the majority of economists to predict the disruptive phenomenon of the crisis in 2008-2009.

### The failure of the predictions and the internal derivation of ideas

One kind of answer to the question indicated above could be formulated as follows: the history of the facts of the last 30 years (IT revolution, globalization, financialisation of the economy, etc.) has progressed at a faster pace than that required by the progress of the economic theory: the formation of an imbalance between the demand and supply of knowledge of an economic-analytical nature.

In this regard, Luigi Spaventa has provided an articulate explanation (*Economists and economics: What does the crisis tell us?*, CEPR, 2009).

The failure of the economists to predict the crisis should be attributed to:  
a – the scientific burden of the past: in particular he refers to the strong influence of the Modigliani-Miller theorem on the irrelevance of the ways in which companies finance their investments, which has hindered the advance of the theory of finance.

b – the high degree of technical difficulties faced in theoretically integrating the microeconomic theories (such as agent theory, asymmetric information, coordination failure, behavioural economics, incomplete markets, ecc) in a new and satisfactory macro model.

### The internal derivation of ideas and .... other external causes

Even Spaventa acknowledged that with onset of the long upswing cycle starting in the early nineteen-nineties, called the Great Moderation, there was a sort of "a permanent structural break in economic history" (p. 4), thereby implicitly admitting the presence of reasons also outside the analytical perimeter of the economy and the process of internal derivation of ideas.

I will now focus my attention on some of these motivations "outside" the internal development of economic ideas, and more specifically, on the important influence certain distorting incentives of the research process could have had, such as:

- A – the psychological cost of going against the current;
- B – the "conservative" role of economic advisers in the Government, Central Banks and many other Institutions.
- C – the formative training of young economists conditioned by research institutions discouraging unconventional (or heterodox) mental attitudes.

### The psychological cost of going against the current

The long cycle of the Great Moderation induced many economists to adopt an optimistic vision of the self-regulation capacities of the markets, in a sort of addiction effect:

Acemoglu: "our belief in a more benign economy made us more optimistic about the stock market and the housing market" (Centre for Economic Policy Research, January 2009).

Mankiw-Taylor: "Everyone agrees that the 1990s and early years of the 21<sup>st</sup> century represented a period of considerable stability" and they implicitly suggest it is due to a largely passive economic policy (see pp. 323-4 of the Italian edition of their manual on *Macroeconomics*, January 2009).

### The psychological cost of going against the current (continued)

The basic thesis advanced here is that within a framework of widespread optimism and stable and long-term growth, the holding of a Cassandra stance (that is to say, the predisposition of economists of going against the mainstream with alarming predictions) entails rising costs (both in psychological terms and with regard to social recognition): whereas the scientific reputation is conserved by staying inside the group, i.e. with conformism, and it is lost with anti-conformism (which should instead be the normal role played by the scientist).

In the same sense Eichengreen: "The more the housing process rose and the longer predictions of their decline looked to be wrong, the lonelier the intellectual nonconformists became. Sociologists may be more familiar than economists with the psychic costs of nonconformity. But because there is a strong external demand for economists' services, they may experience even-stronger economic incentives than their colleagues in other disciplines to conform to the industry-held view. They can thus incur even-greater costs – economic and also psychic – from falling out of step". (*The Last Temptation of Risk*, in *The National Interest online*, 4-30-2009).



### The "conservative" role of economic advisers

Economists who carry out the role of advisor for the public authorities tend to support their views.

On leaving the university classrooms in order to attend those of the ministries or study centres of large corporations or central banks, economists acquire a series of rewarding incentives. The desire emerges to keep this role. This may push them to inadvertently waive their normal professional ethics as scientists, supporting the opinions of those who have invested them with the role of advisor, even though this may be contradictory or uncertain.

In other words, they drop the role of critical economist – which they should instead always hang on to, just like Einaudi's metaphor about the slave sitting at the foot of the conqueror – and take on the role of court economist (I do not refer to intellectual dishonesty, but to the fact that proximity to power could generate a different view of the world and of what can and cannot be done: cfr. Y. Plessner – W. Young, *Economists, Government, and Economic Policymaking ...*)

### The "conservative" role of economic advisers (continued)

Hence, once again the infiltration of a social virus into the work of the economist which can distort the genuine motivations of scientific research.

(Willem Buiter – in "The unfortunate uselessness of most "state of art" academic monetary economics", *Vox*, march 2009 – mentions a case that in some ways is the opposite, that is, in which it is the institution that is subjected to the distorting influence of the advisors it hires: "The Bank of England in 2007 faced the onset of the credit crunch with too much Robert Lucas, Michael Woodford and Robert Merton in its intellectual cupboard" p. 4).

### The formative training of young economists: some insights

Certain reserves regarding the training (universities, specialisation schools, etc.) of young economists have been expressed not only by the economists of the "critique of political economy", but also by other sectors of the scientific community as well.

The most common arguments are three:

- A – the distance between analytical work and its empirical source;
- B – the distorting role that in some research leads to an excess of mathematisation;
- C – the scientific conservatism deriving from the difficulty in breaking away from the ideas of the past.

### The formative training of young economists:

#### Long equations, short memory

M. Geoffrey Hodgson ("After 1929 economics changed: will economists wake up in 2009", in *Real-world economics review*, December 2008) reported the defect of the excess of mathematisation in economic studies speaking about "long equations and short memory".

In general, complaints arrive from various sectors regarding the growing disassociation between the high level of technological apparatus in economic studies and the impoverishing of their cultural background, according to a one-way training process of this type: The more economics curricula are mathematised, the more mathematics will characterise economics in the future.

It is therefore advisable to invest in disciplines with a high humanistic content, such as the history of economics, the philosophy of economics, the study of the relationship between economics and ideology and the like. In particular, the history of economic thought is indicated as an intellectual reference capable of:

- a – raising the level of critical awareness of young economists;
- b – immunising them against the virus of excessive interpretive simplification

### The formative training of young economists The easy passage from hypotheses to dogmas

A different, yet parallel criticism to the one expressed above concerns the fragile epistemological basis of economic studies, contrary to what happens in natural and experimental sciences.

In particular, J. P. Bouchaud ("Economics Need a Scientific Revolution", in *Real-world economics review*, December 2008) criticises the tendency of economists to inadvertently transform the concepts and basic hypotheses into axioms and dogmas ("the rationality of economic agents, the invisible hand and market efficiency" etc.), dogmas that are perpetrated by the education system: "Students do not question theorems they can use without thinking". In actual fact however, "Free markets are wild markets". To overcome this tendency, Bouchaud proposes a closer connection between economic students and the methodology of natural sciences (like physics for example, where the theory of complexity has been developed), and more generally, guidelines in research that place greater importance on empirical observation.

### The formative training of young economists

#### Empirical Research and Inductive Economics: a New Mecca?

Reference to the need for more realistic representations of the economy come from various fronts. For instance, W. Buiter, cit., complains about the failure as well as the absolute prevalence of approaches based on the efficiency markets hypothesis (EMH) and suggests a completely different strategy for studies in the future: "The future surely belongs to behavioural approaches".

Somewhat similar remarks were also made by Eichengreen who, on the basis of his argument on the technology of knowledge ("the IT revolution has altered the lay of intellectual land"), confirms that in the future we will witness a significant growth in empirical research: "The twenty-first century will be the age of inductive economics ... work in economics, including the abstract model building in which theorists engage, will be guided more powerfully by the real-world observation" p. 6.

I think that these standpoints offer a representation of the future of economic studies which is perhaps too clear-cut and categorical. Nevertheless, it seems to me that critical sense invites us to intensify the commitment of economists to better articulate and perhaps extend the epistemological basis of their studies, both "to the right" towards humanistic knowledge, and "to the left" towards the methodology of experimental sciences.

Experimental and Behavioural Knowledge ← Economics → Humanistic Knowledge

### Conclusions

The research institutions can obviously be improved, and this is possible for example by attempting to provide incentives for the economist's critical functions, rather than those that exalt the salvation messages or even cognitive arrogance, rewarding non-conformism rather than conformism.

Mathematics is essential since it has often proved capable of identifying new paths of research and new solutions, together with the achieving of the highest levels of internal consistency in economic reasoning.

However, the lack of a balanced mixture of various types of disciplines and scientific methodologies in formative training of young economists could turn out to be counterproductive, giving rise to a too-restricted cognitive base and a permanent distorting drift in the perception of research that is worth carrying out.

This formative imbalance is surely responsible of the oblivion into which the five economists I mentioned at the beginning have sunk. Their position about the strong limits of knowledge in the economic subjects is a lesson economists should always bear in mind, differently from what it has happened in the years which came before the Great Crisis burst in 2008.