

New Approaches in Economics

What happened after Keynes and Schumpeter?

Kurz :

Chapter 10 : Reactions to Keynes

Chapter 11 : General Equilibrium Theory and Welfare Theory

Chapter 12 : Developments In Selected Fields

Tsoufidis :

Chapter 8: Theory of Capital and Cambridge Controversies

Chapter 17: Economic Theory in Historical Perspective

- Chapter 10 (of Kurz' book): Reactions to Keynes

- Reactions to Keynes
- The Neoclassical Synthesis
- Disequilibrium Macroeconomics
- New Classical Macroeconomics
- Real Business Cycles
- New Keynesian Economics
- Environmental Economics
- Experimental-Behavioral Economics
- Complexity Economics
- Econophysics
- Cognitive Economics
- Neuroeconomics

The Neoclassical Synthesis (Tsoulfidis, ch 11)

- Many economists, soon after the publication of the *General Theory* (1936), set out to formulate and, at the same time, to clarify the difficult and often confusing content of the book.
- Among the first models that were specified was that of John Hicks (1937, 1983), which was to constitute the backbone of what today came to be known as macroeconomics. Hicks sought to express the central propositions of the *General Theory* in terms of equations and graphs in the effort to illuminate the relation between the theory of effective demand* and liquidity preference.
- Furthermore, Hicks clarified these relations with the aid of two curves the IS and the LM, which later became known as the IS–LM curves. Hicks's model became particularly popular in the US through the work of Paul Samuelson (1948) initially and subsequently through Alvin Hansen (1953).

*Difference between demand and effective demand

- Supply and demand are supposed to run together: If there's a demand for your product, you supply it. In practice, this doesn't always work. Consumers who'd love your product may have never heard of it, so they can't demand it. Other consumers would like to buy it, but they can't afford it. Demand is only effective demand when it drives consumers to buy a product.
- If there are people interested in your products or services who nevertheless aren't buying from you, that's latent demand. Effective demand refers to the consumers who are not only interested but willing to spend money with you.

- The IS–LM conceptual apparatus has displayed remarkable longevity and resilience to various critiques and, since the late 1950s or early 1960s, continues to be part of the **formal education of economists**. At the same time, the IS–LM model plays a significant role by virtue of the fact that macroeconomic analyses, regardless of the approach, are cast to a great extent, in terms of the IS–LM representation of the economy.
- This is not to imply that the IS–LM model is without its problems; on the contrary, **many economists expressed scepticism on the validity of the IS–LM as a representation of the *General Theory* and the way in which the economy works.**

Disequilibrium Macroeconomics

(Tsoulfidis, ch 12)

- The neoclassical synthesis prevailed for decades as the authentic interpretation of Keynes. This dominance is attributed, on the one hand, to the simplicity of the presentation of Keynesian ideas and, on the other hand, to the provision of the necessary rationale for the contemplation of fiscal and monetary policy.
- The neoclassical synthesis (of Hicks, Samuelson and Modigliani) was considered the true general theory, as it could be applied to any stage of the business cycle and not only during depressions, as *the General Theory* of Keynes.
- The depressions are caused either by rigid money wages, or because the rate of interest is in the liquidity trap region, or, perhaps even worse, a combination of rigidity of money wages and liquidity trap-interest rate. But once the economy is at its full employment stage, through appropriate government intervention, then the system operates in accordance with the (neo)classical theory.

Liquidity Trap

- <https://www.youtube.com/watch?v=mrmmwDlxE5c>
- <https://www.youtube.com/watch?v=p47uvsjB5E0>

New Classical Macroeconomics

(Tsoulfidis, ch 14)

- The stagflation that afflicted the US and the other economies after the late 1960s shook the economists' faith in **Keynesian economics** or **Monetarism**. The Keynesians could explain the rising **price level**, as a result of an expansionary fiscal policy; the trouble, however, was the continued and persistent recession (**unemployment**), which was inconsistent with their theory. Monetarists, on the other hand, could explain the recession through the tight monetary policy; however, this explanation was inconsistent with the rising price level.

- and Monetarists to explain the key macroeconomic events of the late 1960s and early 1970s discredited their theories and created the need for alternative explanations.

Real Business Cycles (Tsoulfidis, ch 15)

- According to NC economists, the lack of adequate information on the difference between **relative prices** and **the general price level** as well as the monetary shocks constitutes the major causes of fluctuations in the real GDP. This explanation of the source of business fluctuations, on the one hand, questioned the Keynesian orthodoxy and, on the other hand, paved the way for the emergence of the **Real Business Cycles** (henceforth, RBC) and the New Keynesian economics.

- The period from the mid-1960s to the mid-1980s is characterised by a slowdown in the level of economic activity; however, **government's stabilisation** and welfare functions restrained the outbreak of **a major depression** and converted it to a long-lasting stagflation. This is the reason why this time period has been christened the "Silent Depression" and, as in the 1930s, it formed the fertile ground for the flourishing of new economic theories and for the withering away of the old ones.

- Dissatisfaction with the neoclassical synthesis as well as the dead end **road of disequilibrium** macroeconomics paved the way for the rise of **Monetarism**, which, however, soon lost its popularity, and already from the mid-1970s, the researches of New Classical economists with the works of **Lucas** and **Sargent** were leading the way.

- Many among the **New Classical economists** kept a critical stance towards basic propositions of their theory, and in the early 1980s, it led to the development of **the real business cycles** (RBC) approach. Meanwhile, Keynesian economists of the neoclassical synthesis (Tobin, Modigliani and Gordon) continued their critique which was initially levelled against Monetarism and subsequently against the New Classical economics and the RBC.
- The basic plea of New Keynesians is about the fundamental common hypothesis of all these approaches which is continuous market clearing. These new, so to speak, Keynesian economists argued that in actual economies **there are many “obstacles” that hinder markets from complete clearing.**

- The New Keynesians differ from the Keynesians of the neoclassical synthesis and disequilibrium macroeconomics, in that many of them during this long gestation period had accepted the hypothesis of rational expectations. 1 New Keynesians (not necessarily all of them) incorporate, in their analysis, microeconomic principles of rational behaviour of economic agents arguing, for instance, that the rational expectations hypothesis can be integrated profitably in the New Keynesian framework. 2 New Keynesians, like the Monetarists and the New Classicals and unlike the RBC approach, regard demand shocks as the major impulse mechanism that determines the actual stage of the economy. As a consequence, there is an active role for government. According to Mankiw and Romer (1993b), there are two basic propositions of this school of economic thought:
 - 1. Money is not neutral in the short-run.
 - 2. Economic fluctuations are caused by malfunctioning of markets.

Environmental Economics

From modest beginnings in the 1960s, environmental economics has grown to be a major subdiscipline of economics. It combines traditional work in the field of [welfare economics](#) and [the theory of economic growth](#) with more recent perspectives on the political economy of choosing policy instruments and the philosophy of sustainable development. The central tenets are that [environmental problems have their roots in the failure of economic systems to maximize human well-being](#), that environmental quality matters for human well-being and for more traditionally oriented economic growth objectives, and that efficient policy can be achieved through incentive design.

“AN INTELLECTUAL HISTORY OF ENVIRONMENTAL ECONOMICS”, David Pearce, 2002, *Annu. Rev. Energy Environ.*, 27:57–81.

Experimental-Behavioral Economics

- Behavioral Economics is a branch of economics that examines the effects of psychological, social, cognitive, and emotional factors on economic decisions of individuals and institutions and the consequences for market prices, returns and the resource allocation.
- Behavioral economics is firstly considered with the bounds of rationality of economic agents. The study of behavioral economics includes how market decisions are made the mechanisms that drive public choices. (experiments, bias etc.)

Complexity Economics

- Complex dynamics in economics arise from nonlinear systems that do not converge to a fixed point, a limit cycle, or explode or implode exponentially due to endogenous factors. They arise from cybernetics, catastrophe theory, chaos theory, or the varieties of modern complexity theory, including models with heterogeneous, interacting agents. (Complexity in Economics, 2004, J. Barkley Rosser Jr. (ed.))

- The first paper dates from 1962, long before the current discussions of the meaning or nature of complexity in economics. Indeed it is not explicitly about economics at all. And even though its author, [Herbert Simon](#), would eventually receive a Nobel Prize in economics, he was trained as a political scientist and was in the departments of computer science and psychology at Carnegie-Mellon, not economics. He received his Nobel Prize for developing the concept of [bounded rationality](#), and for that alone he deserves to have first place in this compendium of papers about Complexity in Economics. (Complexity in Economics, 2004, J. Barkley Rosser Jr. (ed.))

“I shall not undertake a formal definition of ‘complex systems.’ Roughly, by a complex system I mean one made up of a large number of parts that interact in a nonsimple way. In such systems, **the whole is more than the sum of the parts**, not in an ultimate, metaphysical sense, but in the important pragmatic sense that, given the properties of the parts and the laws of their interaction, it is not a trivial matter to infer the properties of the whole.” (the idea of emergence, the school of fish, feedback mechanism etc.)

(“The Architecture of Complexity”, Herbert Simon, 1962, *Proceedings of the American Philosophical Society*, Vol. 106, No. 6., pp. 467-482.)

Econophysics

- Mantegna and Stanley (1999, p.2) defined econophysics as “a quantitative approach using ideas, models, conceptual and computational methods of [statistical physics](#).”
- The birth of econophysics is usually associated with the publication of Mantegna (1991) in which the author compared the occurrence of extreme variations on the financial market with the occurrence of earthquakes whose observations can statistically be described through a power law. Mantegna and Stanley (1999) or Jovanovic and Schinckus (2013) explained that this initial article opened the door to an increasing number of empirical works observing power laws in socio-economic phenomena.

“The multidisciplinary field of econophysics ...[as] a neologism that denotes the activities of physicists who are working on economic problems to test a variety of new conceptual approaches deriving from the physical sciences” [2, pp. viii-ix].

(The Nature and Future of Econophysics, J. Barkley Rosser, Jr.)

Cognitive Economics

- Cognitive science is a child of the 1950s, the product of a time when [psychology](#), [anthropology](#) and [linguistics](#) were redefining themselves and computer science and neuroscience as disciplines were coming into existence. Psychology could not participate in the cognitive revolution until it had freed itself from behaviorism, thus restoring cognition to scientific respectability. By then, it was becoming clear in several disciplines that the solution to some of their problems depended crucially on solving problems traditionally allocated to other disciplines. (“The cognitive revolution: a historical perspective”, George A. Miller, 2003, RENDS in Cognitive Sciences Vol.7 No.3)

Neuroeconomics

Neuroscience uses [imaging of brain activity and other techniques to infer details about how the brain works](#). The brain is the ultimate “black box.” The foundations of economic theory were constructed assuming that details about the functioning of the brain’s black box would not be known.

Scientific technologies are not just tools scientists use to explore areas of interest. New tools also *define* new scientific fields and erase old boundaries. The telescope created astronomy by elevating the science from pure cosmological speculation. The microscope made possible similar advances in biology. The same is true of economics. Its boundaries have been constantly reshaped by tools such as mathematical, econometric, and simulation methods. Likewise, the current surge of interest in neuroscience by psychologists emerged largely from new methods, and the methods may productively blur the boundaries of economics and psychology. This section reviews some of these methods.

“Neuroeconomics: How Neuroscience Can Inform Economics”, COLIN CAMERER, GEORGE LOEWENSTEIN, *and* DRAZEN PRELEC, 2005, *Journal of Economic Literature* Vol. XLIII, pp. 9–64.

The Paradox of Choice

Psychologist Barry Schwartz takes aim at a central tenet of western societies: freedom of choice. In Schwartz's estimation, choice has made us not freer but more paralyzed, not happier but more dissatisfied.

https://www.ted.com/talks/barry_schwartz_the_paradox_of_choice#t-1161035

Paul Samuelson notes:

“[I]t is better to have a model with inexact foundations that gives you a good grip to handle reality than to wait for better foundations or to continue to use a model with good foundations that is not usefully relevant to explain the phenomena that we have to explain.”

(Samuelson 1988, p. 295)