


Frank Jan de Graaf argues that the dominance of neoclassical economic thinking in academia has contributed to the economic crisis

Economics, scientific doubt & history.

Alan Greenspan
former chairman of the
American Federal Reserve

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The most impressive *mea culpa* of the past year was undoubtedly given by Alan Greenspan, former chairman of the American Federal Reserve, or central bank. In a hearing before Congress on the credit crisis, he stated: "I have made the error to expect that the self-interest of organisations, especially banks and others, was the best way to protect shareholders, capital and business..."

In reply, the chairman of the committee asked if he felt that his view of the world, his ideology, was inappropriate and had failed. Mr Greenspan agreed.

With his apology Mr Greenspan recognised the failure of the neoclassical approach to economics, which assumes that the rational, selfish behaviour of people in free markets ultimately leads to the highest social usefulness.

It must have been a shock to the economics of the past few decades. Subjects such as public finance, corporate finance, banking theory, risk management and management accounting are all largely based on the neoclassical approach. Most recent appointed professors have started their work with ideas based on a neoclassical fundament and its methodological preferences.

Neoclassical economic thinking is not bad in itself. It has brought much good, even.

In the 1980s politicians such as Margaret Thatcher in Britain and Ronald Reagan in America got their economies back on track based on neoclassical theories. At the time economic thinking in many Western European countries was still dominated by Marxist and socialist thinking.

Despite the current criticism, radical policies proved to be a blessing in the long term.

But now the downside of neoclassical theory has occurred. Failing financial markets have plunged the global economy into crisis.

It is, therefore, high time for a debate on economic concepts as taught in universities and business schools. Are students really trained to think critically about economic theory and the consequences when economic theories are put into practice?

Such a debate must focus on the sustainability of four assumptions behind current economic science.

In recent years, students have learned that the economy is made up of (1) rational individuals seeking (2) maximum satisfaction who are (3) fully informed in a (4) market that strives for equilibrium.

This has led to a generation of economists who believe in market forces but who can only build models and are mostly adding nuances to an existing economic theory. In the last ten years, Nobel Prizes have been given to economists who have modified assumptions on market equilibrium,

rational action, optimal satisfaction of needs and comprehensive information.

The one-sidedness of academia has major implications for the real world.

The neoclassical theory has been copied by investors, bankers, risk managers and regulators such as Mr Greenspan without any nuance. Many investors really believe that market-driven selfishness is a good thing and that performance can be measured objectively. The exaggeration of scientific models was directly introduced into the real world. This led to a crooked view of reality among banks, insurers, pension funds and advisors.

The implications for the financial markets were unhealthy. Among investors, portfolio theory is all powerful. This led to most pension funds investing their money blindly, trusting on indices. For example, the Norwegian Petroleum Fund has, because of this approach, more than 5,000 companies in its portfolio. And due to this index-based approach, shareholders are unable to monitor individual organisations effectively.

Moreover, index investing starts from the idea that the shareholders in a company are fully aware of what happens. We now know the reverse side of this technical approach. Because investors did not want to know where they invested, charlatans and swindlers had an easy life.

Another unhealthy attitude is the near exclusive focus on financial data. We have seen that ratings or approved financial statements really say very little about reality. To get clear insight into risks, we have to look at all aspects of an organisation.

In their classes academics have not warned students sufficiently about the weaknesses of their knowledge and methods. Building models is an economist's strong and weak point. By definition models are based on limited assumptions including psychology, historical developments, human failure and group ideology.

Current economists' methodological blindness is inconsistent with academic tradition, which states that any theory is only as good as its own assumptions. A good economist knows the weaknesses of his theory and methodology and is prepared to debate them.

Frits Bolkestein, former European Union Commissioner of Competition, states in his book *The Two Lights of the Statesman* that policymakers and politicians decide best when their decisions are based on logic and historical insight. The tragedy of current economic science is that it only allows itself to be enlightened by logic.

Economic models have great logical elegance but lack the other, historical, light. Historical knowledge and historical methods are almost extinct. The best fruit of historical knowledge is humility. Historians, like no one else, are aware of the difficulty of truly understanding and determining facts even when they have already happened.



5,000

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History has also shown that the apparently obvious solutions in a crisis may not necessarily be the best. In the 1930s Depression governments saved money because that was what they were accustomed to do in times of crisis. In today's crisis money is being spent whereas savings may be the only way out of it.

However, widening their orderly world of clear assumptions and models to include different disciplines makes economists uneasy. But it is incorrect to assume that economic knowledge is applied correctly if academic economists simply stick to strict methodological rules. Even more striking, because economic models are independent of reality, there is room for abuse of scientific knowledge and methods.

When the credit crisis first broke out, I raised some questions about a company with huge debts that now had its cash "securitised". A respected colleague waved my doubt away – the market would normalise and the company would benefit for many years to come from this financial innovation. My common sense struggled with this. A company full of debt would by securitisation of its cash flows be able to get money for a better price?

Why did I not say during this incident that we were all wrong? As people, we are forced to move with the masses because we fear for our social position.

Three changes are needed in faculties of business and economics.

First, the critical and independent evolution of the mind must again be central. Each dean has to reconsider if this is happening in his or her department and he or she must ensure that a department is not used to promote a new world order, whether it is neoclassical or Marxist. Economic development requires academic discussion and debate. One theory and method should never have any dominion.

Second, economists must abandon their presumptuous attitude to methodology. Methodologists understand that a model is only as good as the assumptions it is based on. This means that economists will have to question whether they are using the correct assumptions. These assumptions always have an ideological component that researchers should report. This means that economics should encourage multiple approaches. It is not just about building models.

Third is the role of the users of economic research. Policy makers and journalists should not be intimidated by jargon and perceived authority. Economic research and analysis must be understood and socially relevant.

Within academia, especially when social facts are under scrutiny, everything starts and ends with learning based on academic scepticism. Public discussion has to be part of that process. **gf**

FURTHER INFORMATION

A Dutch version of this article first appeared in *Het Financieele Dagblad*, the main financial paper in the Netherlands, 5 September 2009.

The author would like to thank Harry Pieter de Graaf and Sean Kidney for their comments.

ABOUT THE AUTHOR

Dr Frank Jan de Graaf is Professor of International Business at the Hanze University of Applied Sciences, Groningen, Netherlands. He also holds a part-time appointment at the faculty of economics and econometrics at the University of Amsterdam