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Essay and Commentary | Free Access

The virtues and vices of equilibrium and the future of financial economics

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Abstract

The use of equilibrium models in economics springs from the desire for parsimonious models of economic phenomena that take human reasoning into account. This approach has been the cornerstone of modern economic theory. We explain why this is so, extolling the virtues of equilibrium theory; then we present a critique and describe why this approach is inherently limited, and why economics needs to move in new directions if it is to continue to make progress. We stress that this shouldn't be a question of dogma, and should be resolved empirically. There are situations where equilibrium models provide useful predictions and there are situations where they can never provide useful predictions. There are also many situations where the jury is still out, i.e., where so far they fail to provide a good description of the world, but where proper extensions might change this. Our goal is to convince the skeptics that equilibrium models can be useful, but also to make traditional economists more aware of the limitations of equilibrium models. We sketch some alternative approaches and discuss why they should play an important role in future research in economics. © 2008 Wiley Periodicals, Inc. Complexity, 2009

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