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Articles

Institutions in the economy and some institutions of mainstream economics: From the late 1970s to the 2008 financial and economic crisis

David Dequech

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ABSTRACT

This article proposes a conceptual and theoretical institutional approach to the relations between the economy and economics and uses it to examine, through a structured survey of the literature, the relations between institutions in the economy and the institutions of mainstream economics, macroeconomics, and financial economics, highlighting issues related to the financial and macroeconomic crisis and focusing on the United States from the late 1970s to 2008. Institutions are socially shared systems of rules of behavior or of thought. Some systems of mental and behavioral rules are socially shared among economic agents and policymakers in part because they are socially shared among academic economists. They may exert on economic agents and policymakers some of the same types of influence they have on economists. On the

other hand, there are important limits to the influence of the institutions of economics outside academia, and institutions in the economy also influence the institutions of economics.

KEYWORDS:

Crisis finance institutions macroeconomy mainstream economics

JEL CLASSIFICATIONS:

A11 A14 E02 G01 G10

Notes

[1]This concept of conventions is intentionally less restrictive than game-theoretic ones. It is, however, more specific than the concepts underlying the analyses of conventions in the American economy by political scientists Blyth (2002) and Nelson and Katzenstein (2014). The nonsuperiority of conventions raises the question of how some rules become part of mainstream economics without being demonstrably superior to one or more alternatives. On this and on the mechanisms through which rules become conventions, see, again, Dequech (2017).

[2]Several references will be provided in the next sections, together with examples of the arguments made in this section.

[3]For Campbell (1998, p. 390), prestigious academic ideas have an advantage when it comes to influencing what he calls paradigms, "broad cognitive constraints on the range of solutions that actors perceive and deem useful for solving problems," as distinct from "programs," which are "precise, concrete, and policy-specific courses of action articulated consciously by policy makers and experts."

[4]This issue is closely related to the debate on the performativity of economics. Some references are mentioned below, but lack of space requires that this debate be examined in a separate paper.

[5]This argument partly resembles Bourdieu and Wacquant's (1992: 70) discussion of the scholastic fallacy. Unsure of how far the resemblance goes, I have decided not to use

the same expression.

[6]Although the focus here is on mainstream economics, there also exist many nonmainstream mathematical models.

[7]Fundamental uncertainty is the lack of knowledge resulting from the possibility of nonpredetermined structural changes. Procedural uncertainty results from the contrast between the complexity of the situation and the agents' limited capabilities. See Dequech (2011).

[8]Dow (2015) did not explain which institutions and conventions were those. Conventions, informal social norms and contracts emerge among private agents, but some institutions are implemented by policy. Perhaps Dow is thinking of reforms implemented in the 1930s (such as the New Deal in the U.S.) and/or the Bretton Woods system. Some policies may aim at reducing instability, but this does not necessarily mean that they are guided by an economic theory that emphasizes fundamental uncertainty or by any other academic theory.

[9]Campbell (1998) pointed out the influence of mainstream economics on the paradigms employed by actors in the 1970s/1980s but associates neoclassical economics more strongly with free market ideas and less with the kind of Keynesianism that prevailed in the 1950s and 1960s, while I see neoclassical economics as compatible with both.

[10]Among the earlier developers of VaR was Kenneth Bargade (PhD in economics, Princeton, 1975). For a critique of VaR, see Crotty (2009).

[11]On the origins and diffusion of the copula method and the influence of mainstream financial economics, see MacKenzie and Spears (2014).

[12]Confidence in risk-assessment models also underlies proposals for bailing in banks (Dow, 2016a).

[13]Nelson and Katzenstein (2014, p. 370) interpreted this example in terms of excessive risk taking, which is similar to exaggerated confidence. The argument that confidence depends on both uncertainty perception and uncertainty aversion and the present discussion of the influence of mainstream economics on uncertainty perception mean that there is an institutional factor behind excessive risk taking that has been neglected by mainstream economics.

[14]The reputation of the rating agencies was hurt, but, as Carruthers (2010, p. 177) argued, the incentive of reputational sanctions had not been enough, and, at the time, the agencies had “no legal liability.” For a few years after 2008, the rating agencies did not seem to have been inflicted any harsh punishment, in the market or elsewhere. However, S&P, in 2015, and Moody’s, in 2017, agreed to pay US$1.4 billion and US$900 million, respectively, to settle lawsuits.

[15]The efficient market hypothesis also “provided a compelling rationale for the re-orientation of companies toward shareholder value. … [T]he science and institutions of finance co-evolved to a degree unknown in most other domains, often with the aid of financial economists themselves’ (Davis, 2009, pp. 20, 22, 56, emphasis added).

[16]Blyth (2002, pp. 169–171) referred to monetarism as a new convention of both the Fed and financial markets. See also the references below to Abolafia (2012) on legitimation.

[17]According to Krippner (2011, p. 117), “[u]nlike academic monetarists, the FOMC staff was never under any illusion that it would be possible to precisely control the money supply.”

[18]Relatedly, Dow (2016b) examined differences in how policymakers, market players and households frame finance.

[19]On Friedman and funding, see also Van Horn and Mirowski (2009, pp. 166–168).

Additional information

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Notes on contributors

David Dequech

David Dequech is with the Economics Department at the University of Campinas, Sao Paulo, Brazil.

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