Pedagological Lessons From the Financial Crisis: The Need for Pluralism

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Alfred Marshall wrote in the preface to his *Principles of Economics*, "economic conditions are constantly changing, and each generation looks at its own problems in its own way" (Marshall 1946: v). Indeed every generation of scholars should ask new questions, look at problems from different perspectives and devise new theoretical frameworks if established ones become inefficacious.

Unfortunately, neoclassical economics which has dominated economics since the late 19th century, has hermetically sealed itself from honest self-evaluation; it remains "ahistorical, developing models that abstract business organizations, their debt dynamics and the state of the macroeconomy" (Rima 2002: 409). Its core propositions are accepted as faith and cannot be challenged empirically. Because of its reluctance to self-examine, neoclassical economics has failed to understand and solve the most important problems of our generation including poverty, inequality, global warming and the growing financialization of capital[1].

Neoclassical economics offers only shards of truth, snippets of real world behavior while masquerading as scientific by proffering a grand, unifying theory of human behavior. This is insidious since it arrogantly misinforms policymakers and leads to inefficacious policies. Solving our generation's pressing problems requires interdisciplinary knowledge and an understanding of diverse methodological views. No discipline has a monopoly on policy making and one should impugn any claim otherwise.

The objective of this paper is to elucidate the current global financial crisis from a pluralist perspective. Section one will briefly analyze the differences in pedagogy between mainstream and pluralist economics. Section two will discuss the contours of the current financial crisis. And section three will illustrate the efficacy of the pluralist approach vis-a-vis mainstream economics from a pedagogical perspective. This paper will lay the groundwork for the construction of pluralist solutions to the crisis and integrate this knowledge into economic pedagogy.

The Need for Pluralism

The criticism of mainstream economics is voluminous[2] and well-familiar to readers of this journal.

One strand of criticism relevant for this paper is as Geoffrey Hodgson articulates nicely, " the inward looking obsession with technicalities at the expense of the understanding of reality has made economics ill-equipped to deal with major transformations and crises" (Hodgson 2001: 3) Thus, unfortunately, "mainstream theory continues to stand aloof from the world of fact. Students of mainstream economics learn nothing about the actual economy, acquiring instead a trained

[1]. According to Kevin Phillips, financialization is "a process whereby financial services, broadly construed, take over the dominant economic, cultural and political role in a national economy" (Phillips 2006: 268).

[2]. For a sampling see Fullbrook (2005), Hodgson (2001) and Keen (2001).

incapacity to comprehend economic realities" (Dowd 2004: xiv).

In a widely circulated petition, French University students pleaded,

> Most of us have chosen to study economics so as to acquire a deep understanding of the economic phenomena with which citizens of today are confronted. But the teaching that is offered, that is to say for the most part neoclassical theory or approaches derived from it, does not generally answer this expectation.

At the same time, a clarion call for pluralism has emanated from within the economics profession The *International Review of Economic Education* will publish a forthcoming special issue on pluralism in economics and a new journal, devoted to pluralism in economic education, *The International Journal of Pluralism and Economics Education*, published by Inderscience will debut in January 2009.

Key elements of pluralism include respect for diversity and alternative views, toleration, willingness to learn, curiosity and friendliness – all necessary to enable students to forge solutions to today's complex problems. Although the mainstream congratulates itself for relaxing the more severe and constricting assumptions (Coyle 2007) it nevertheless remains committed to methodological monism, disparaging contributions from other social scientists,

> anthropologists and sociologists have repeatedly told economists about the importance of culture, norms and social structure. Economists have not listened, however, mainly because these other fields have not developed powerful techniques for analyzing social influences on behavior (Becker and Murphy 2000: 3).

Reality is not however, subdivided into disciplines. Pluralism is necessary to solve today's complex and interrelated problems,

> the denial of pluralism . . . denies the mainstream of a major source of intellectual drive. In ideas, as in nature, variety is the evolutionary fuel. When pluralism and variety disappear, innovation and progress may slow to a halt. . .pluralism is necessary for innovation and scientific advance. A science that denies pluralism may enjoy a brief and absolute hegemony but will eventually suffer a dull death" (Hodgson 2001: 13.)

Understanding History: A Prelude to Understanding the Current Financial Crisis

Overextended militarily, indebted to the rest of the world, gorging on imports, its decreased prestige underscored by the falling dollar, the United States is in decline. Like other global powers before them (Spain in the 16th century, Netherlands in the 17th, Great Britain in the 19th) the United States imbues a misplaced hubris, a pervasive belief that their nation is special. In addition, as both cause and effect of decline, global powers shift from manufacturing and the production of goods and services to finance and speculation, "as the imperial apogees approached, the potential return from investing money domestically came to seem inadequate, and . . . creditors and financial classes began to move more and more funds into overseas investments" (Phillips 2006: 306). Content to let the rest of the world produce for their consumption, Madrid, Amsterdam, London and now New York became centers of global finance.

Paul Sweezy, one of the first to recognize the current financial phase in the United Stares, wrote,

> As the global economy stagnated during the 1970s . . . the objective became to absorb the enormous economic surplus . The result was a financial superstructure sitting on top of the global economy . . . made up of banks and a host of dealers in a bewildering variety of financial assets and services all interconnected by a network of markets (Sweezy 1994: 7).

Indeed, "this shift in economic activity from production to finance . . . is one of the main issues of our time (Foster 2006: 1).

In the United States, finance, insurance, real estate, rental and leasing comprise 21 percent of total GDP.(Howells and Barefoot 2007: 19). The Federal Reserve is "ever-ready, along with the world's major central banks, to pump liquidity into the system at any sign of a major disturbance" (Foster 2006: 10). It does so not to benefit the majority of citizens, but for the minority finance and banking industry, since finance distributes its concentrated profits to a much smaller slice of the population" (Phillips 2006: 281). Thus, increasing income inequality is a palpable characteristic of an empire in decline.[3]

The concentration of financial resources attenuates the efficacy of government macro policy while helping to enact business-friendly policies both home and abroad (Peet 2007: 50). In the United States, the total nonfinancial credit-market debt [of] $23 trillion easily supplants the $3 trillion money supply (Phillips 2006: 273). In addition, the increased clout of the finacial services industry was instrument in repeal of the Glass-Steagall Act, and the Financial Services Modernization Act which enabled banks to establish a new category of holding companies that included nonfinancial corporations (Phillips 2006: 291).

Finance is currently an important global industry. Nine of the largest twenty-five global corporations are financial institutions,[4] collectively earning 12.7 trillion dollars in revenue in 2006 (Fortune 2007). Capital exports are increasing more rapidly and are more significant than export of goods/services at 16 percent of world GDP in 2005. Between 1.2 trillion and 1.5 trillion dollars are traded each day on the markets – more than 60 times needed to settle actual transactions in goods and services (Toussaint 2005: 15).

Financial crisis as a global power declines, is not an historical aberration but intrinsic to the tectonic shifting of capitalist powers. Historical knowledge of capitalist developments is thus

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[3]. Of course, income inequality is intrinsic to capitalist development, but becomes more severe as capitalist powers decline. Stats

[4]. These include: #13 ING (Netherlands, 158 billion in revenue), #14 Citigroup (USA, $146 billion), #15 AXA (France, $139 billion), #18 Credit Agricole Bank (France, $128 billion), #19 Alliance (Germany, $125 billion), #20 Fortis (Belgium, $121 billion), #21 Bank of America (USA, $117 billion), #22 (HSBC, $115 billion), #22 AIG (USA, $113 billion), #25 BNP Paribas (France, $109 billion).

crucial to understand the current crisis and to "shake off the hypnotic effects of contemporary ideology and economic theory"(Dowd 2004: xiii).

As mainstream economics developed during the 19th century, it "abstracted from history and ignoring significant economic, social, cultural and technological changes – the most the world has ever seen" (Dowd 2004: 81). While neoclassical economics refined its mathematical technique, becoming more esoteric and abstract, capitalist economies underwent intense centralization and concentration: stronger companies acquired weaker ones, joining together in trusts, cartels and holding companies aimed at eliminating cutthroat competition while stabilizing price and output. Capitalists in core countries sought new markets and cheaper raw materials. As a result, small-scale, domestically- oriented capitalism (with the notable exception of the Untied Kingdom) became the monopolistically- controlled imperialist system of the 20th century (Dowd 2004).

Unfortunately for mainstream economics "historical knowledge [has become] an insignificant extra for young economists today, something they can ill afford to spend their valuable time acquiring" (Chang 2004: 279). Rather than empirically investigating how real firms behave mainstream economics retreated into a "fairyland of make-believe assumptions to quickly become "the science of economizing, maximizing and efficiency . . . [thus serving] as a theory for working within and preserving the status quo" (Dowd 2004: 83). Mainstream economics has also parried the evolution of the corporation, constructing the manifestation of its power to industry concentration ignoring that"the real power is not so much in corporate boardrooms as in the financial markets" (Sweezy 1994: 10). Indeed, finance sets the pace and the rules for the management of the cash flow of nonfinancial firms (Foster 2006: 7). As a result, students of mainstream economics have a misinformed and misinformed picture of the behavior of the firm, along with a gratuitous optimism of the efficacy of the free market.

John Sutton perceptively noted that students are perplexed by austere assumptions and a simplifying model and "those students that remain troubled . . .have quit the field; those that remain are socialized and no longer ask about such things" (quoted in Coyle 2007: 249).

Insights from Pluralism

The debate over pluralism is fruitful and multifaceted (Dow 2007). How to incorporate pluralism into pedagogy is discussed in Reardon (2009). For our purposes, two strands of pluralism are necessary. In order to solve today's problems it is necessary to go beyond economics to gain insight from other social sciences, "one cannot understand contemporary societies very well, unless politics, economics, psychology and other social sciences are all brought together to study the complexities of modern life" (Bowles et al. 2005: 51). In order for economics to be useful and enable the student to parry the eventual ideological onslaught, its systematic study at the university level must be prefaced by one semester in the history of capitalist evolution, paying close attention to the rise and fall of the global empires. The course should either be team-taught with an historian. The course can introduce students to the great economists and how they developed theory in response to the problems of the day. Not only will this elucidate the historical roots of many theories, but instill efficacious optimism among economics majors to solving contemporary problems.

A second strand of pluralism necessary for this paper is that other schools of thought within economics are necessary to elucidate understanding. Ideally such a course can either take the place of traditional principles course, based on the thematic concept of the great economists (Knoedler and Underwood 2003) or be incorporated directly into the principles course (Nelson 2009). Both suggestions are parried with two criticisms: (1) students are already overburdened with course requirements and (2) incorporating pluralist ideals into existing courses will 'crowd-out' discussion of necessary and traditional topics. We respond by stating that pluralism is necessary in order to elucidate contemporary problems and form solutions and teaching the traditional topics is part of the problem. It is important to reform economics pedagogy.[5] As pluralists, it is our job to convince students, faculty and administrators the importance of our suggestions (Reardon 2004).

In the remainder of this section we will discuss how different schools within economics can elucidate the current crisis.

Starting point is the Marxian concept of surplus value, either ignored, disparaged or misunderstood by the mainstream. But this concept is amenable to understanding by today's students. One contemporary text piques student interest with the following questions, "What do the Taj Mahal, the pyramids, the Great Wall and the slaveholders' mansions have in common?. . . Where did the rulers of these societies - kings, bishops, emperors or slaveholders – obtain the means to realize such magnificent plans?"(Bowles et al. 2005: 93). Students are cognizant of the great movement of wealth across the plant, how some benefit, but many are vulnerable. The more perceptive students find this hard to reconcile with a beneficent market attaining a just equilibrium.

Exploitation is necessary for the continuation of surplus extraction, obtained from the working population . . . suggesting the continuation of this system will only result in more surplus exploitation (Foster 2006: 10-11). It squeezes the surplus from the real economy while magnifying the surplus several-fold. This explains the uneven distribution of income under financialization. Like a hurricane needs warm ocean temperatures for energy, the financial system needs constant cash infusions to sustain itself. It is no coincidence that the financial superstructure has ascended with conservative economics, the latter empathizing unrestricted mobility of capital and free markets, designed to increase returns to capital.

Surplus value underscores the existence of power, ignored by mainstream economists but absolutely essential to understand today's problems, and allows global powers to search the globe for higher profits. Power and its attendant ability to exploit was a central concern of classical economists, but was "swept under the rug" by neoclassical economics who disingenuously and gratuitously assumed that factors of production receive the value of their marginal productivity (Dowd 2004).

A second useful concept is the insights from Veblen, another important economist ignored by the mainstream.[6] Veblen's prolific analysis is impossible to survey in one paper but

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[5]. Shearman and Smith argue that in the expected social, environmental and economic crises of the near future, universities must "train a new group of thinkers and activists to fearlessly tackle [these] problems" (2007: 141).

[6]. In a myopically unsuccessful effort to understand social behavior in a market context,

four points, all central tenets of pluralism, are germane. One, the incongruence between the interests of firm managers, the community at large and the survival of the firm as an institution (Veblen 1996: 157). Second, is dominance of finance in modern capitalism,

> the fortune of property owners is to a large extent dependent on the discretion of others – the owners of intangible property; and the management of the industrial equipment – tends strongly to center in the hands of men who do not own the industrial equipment, and who have only a remote interest in [its] efficient working. The property of those who own less, or who own only material goods, is administered by those who own more, especially of immaterial goods; and the material processes of industry are under the control of men whose interest centers on an increased value of the immaterial assets (Veblen 1996: 175-176).

Third, rather than assume money as neutral and exogenous, money's role in a capitalist economy is non-neutral and endogenous. Money represents private wealth– the link between present and future. A capitalist monetary system is based on credit relations, financial assets and uncertainty. Fourth,
instability rather than equilibrium characterizes a capitalist economy.

The importance of instability was incorporated by Keynes, Minsky and others. Minsky, for example, argued that expectations and uncertainty are crucial, leading to endogenous and often unstable creation of credit. Thus "it is finance that acts as the sometimes dampening, sometimes amplifying governor of investment. As a result finance sets the pace of investment" (Minsky 1976:130). The pace of investment, in turn determines income and employment. Increased demand for investment increases demand for funding – a function of bankers' expectation of future incomes. Increased investment leads to higher profit rates, increasing future expectations and the present value of capital assets. The credit boom intensifies while liquidity preferences decline. The resulting speculative portfolios are extremely vulnerable to changes in interest rates and asset prices. When profits decline as they inevitably do, credit and external funding becomes constricted. Thus financial institutions play a crucial role in determining investment. This insight was earlier amplified by Veblen,

> increased demand and enhanced prices . . .increase the prospective earnings [which] may eventually be realized in full measure, or they may turn out to have been putative earnings only . . The business effect is much the same . . .The expectation leads to [high] bids for equipment and supplies. Thereby the effective (market) capitalization is increased to answer to the increased prospective earnings. This recapitalization . . . increases the value of this property as collateral. The inflated property, in effect collateral even without a formal extension in the way of loans; because in effect, the contracts entered into are a credit extension, and because the property of the contracting parties is liable to be drawn into liquidation in case of non-fulfillment of the contracts" (Veblen 1996: 197-198).

Becker and Murphy are genuinely surprised that Thorstein Veblen, one the few heterodox authors cited (only, however, for his *Theory of the Leisure Class)* "anticipated many of our results" although of course "he does not make a systematic analysis" (p. 5).

Lessons Learned

Preparing students for the 21st century by giving them a map of the 19th century (a poor one at that) is worse than no map at all; the student is better off without any mainstream economics since the he/she can intuitively grasp the problem.

Does this mean that mainstream economics should not be taught at all? Not necessarily for four reasons. One, it should be studied as one ideology, among many others, and perhaps within a narrow constrain of parameters it can be useful. Second, it is necessary to learn in order "to teach against it" (Dowd 2004: 234, note 26). Third, it illuminates that neoclassical economics is value-laden, an "ideology supporting and strengthening business" (Dowd 2004: 197). An finally to understand its crucial role in the ascendancy of free market ideology and the deregulation of financial markets, which has intensified since the 1980s.

Deregulation has strengthened the financial sector increasing its strength and political clout, evidenced by the passage of favorable legislation.

And in addition, the recent crisis has made clear that "The Fed's polices, however shrewd were not rooted in abstraction of the national interest but in pursuit of its statutory mandate to protect the U.S. banking and payments system, now inseparable from the broadly defined financial services sector" (Phillips 2006: 279). According to Minsky (1975) the development of financial markets increases the liquidity of capital assets and the ability to generate cash flows by selling a capital asset without large price concessions. The demand for financial assets generated by this new debt cycle has included sophisticated risk evaluation procedures. And as regulatory oversight has waned, "potential benefits from manipulation and new financial innovations have also appeared" (Hake 2005: 609).

Pluralism can elucidate the recent housing crisis. Since 1981, thirty year mortgage rates have been declining, reaching a record low in 2003, while at the same time, housing prices steadily increased from 1991 to 2005. Thus, the cost of financing was decreasing while the capital asset price was increasing. Increased profits in the housing market encourage more investment. Due to increased clout of the financial industry, lending requirements were liberalized. The industry encouraged speculation dependent on future housing prices, the future price of securitzed assets and the renewal of lending operations. This conduct was sustainable until housing prices began dropping and the previous risky lending led to an epidemic of foreclosures. As housing prices decreased, profits fell, and marginal home buyers who invested in speculative mortgages could not pay were subject to foreclosure.

Mainstream economists, assume that financial markets efficaciously transfer funds; and furthermore that deregulation was necessary to increase efficiency and the supply of loanable funds. Yes, some consumers acted irrationally by borrowing beyond their means, and some banks unscrupulously lent money, but market forces are already punishing these miscreants, and further legislation is not necessary other than to increase the flow of information and the transparency of transactions. The central bank should carefully monitor the situation, intervening when necessary.

Contrast this with the pluralist view that argues that not only did the increased clout of the industry result in favorable legislation but it systematically influenced consumer preferences. And given the importance of global debt, any one central bank is inefficacious in finding solutions, which must be done as Keynes argued during the 1940s, via coherent and democratic international cooperation. As Minsky warned, "finance cannot be left to the free markets" (Minsky 1986: 292).

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