

Selected Theories of the Business Cycle in Terms of “Econsochology”

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The business cycle has been studied, rejected, re-studied and re-accepted during various periods of the Twentieth Century, especially after the writings of Lord Keynes in *The General Theory of Employment, Interest, and Money*, 1936. The point of this paper will be to briefly discuss selected business cycles analysis—newer and older—in terms of a broad approach within the framework of major parts of Institutional (Evolutionary) and Post Keynesian Economic Analysis taking into consideration historic, economic, sociological, psychological analysis—hence the term “Econsochology.” In doing so, the “molecular “concept of the Institutionalists will be utilized as a connecting theme throughout.

Selected Institutional and Post Keynesian concepts

The Institutionalists, unlike the Neo-Classicalists, stress the concept and importance of institutions. For example, the importance of the existence or non-existence of a central bank is important; and the development of the modern corporation versus the “orthodox”, Neo-Classical “village fair” is also important. The “village fair” had closed borders in a moment of time and all transactions were supposedly fulfilled therein. In the financial world of modern capitalism, as the Post Keynesian Hyman Minsky (Minsky, 1977, 1982) tells us, is not with fixed borders, fixed time, and involves complex, financial transactions involving the future and, thus, risk. Both the Institutional and Post Keynesian analysis are cognizant of the

importance of institutions and their behavior (Brazelton, 1981). Institutions exist, and they make a difference, as do their methods of operation.

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Both the Institutionalists and the Post Keynesians are also cognizant of social change. Unlike the Neo-Classicalists, both believe that change takes place and that such change is important. Not only is the American economy of 2005 different from that of 1905, but the institutions of it have changed as well in terms of behavior, purpose and importance. In 1905, there was no Federal Reserve in the United States and bank panics occurred almost from decade to decade. After 1913, there was a Federal Reserve, but it did not realize its ability to greatly affect the economy (at least not as much as after the 1930s and beyond) and was under the theoretical concepts of Neo-Classicalism. Now, in 2005, its power is better realized and more effectively utilized. Changes took place in financial institutions; in how they operate; and in financial markets as well. A lender of last resort makes a difference. If one should view these changes in terms of Institutional Analysis, one would be reminded of the “Veblenian Dichotomy” and the “on-going” struggle between the “backward-binding” institutions of the past and present versus the “forward-urging” technological improvements available for the future. One may argue that new technology can be harmful (environmentally, for example), but such harm may not be the fault of the technology, per se; but, rather, how the users use, misuse, or over use it.

In terms of socio-economic change as discussed above and in the Veblenian Dichotomy of the Institutionalists, the Post Keynesians have added two separate but related concepts. Paul Davidson, (Davidson, Louise, 1991a, 1991b), (Davidson, Paul, 1993, 1996, 2002), for example, reminds us of the dual concepts of

“non-ergodicity” and “hysteresis”. The Neo-Classical concept is that after the economy re-adjusts to a disturbance back to equilibrium, it is essentially the same as before. Full employment returns to full employment and nothing else changed or is mentioned. But other things have and do happen! The world of economics analysis and policy after the 1930s was never like the prior world of economic analysis and policy. There had occurred the Depression of the 1930s, World War II, Bretton Woods, and John Maynard Keynes! Thus, Davidson reminds us of the concepts of “non-ergodicity” and “hysteresis”. The former points out that after a system recovers from a major disequilibrium, the probability that it will be forever different than before is significant. The Federal Reserve changed from 1930 to 1950 and beyond—as an institution and as to policies. The economy changed and is changing; as did the institutions involved; as did some sectors grow and some sectors diminished—agriculture, industry, distributions between, technology, services, government, etc. On the other hand, the concept of “hysteresis” indicates that a system depends upon its past history—historical events, their implications and the changed conditions. Thus, not only will a system not return to its previous status (non-ergodic) after a significant disequilibrium; it will in the future be influenced by the conditions and implications of that past disequilibrium (hysteresis). This is a further confirmation of the “on-going” process of technological, social and technological change stressed by the Institutionalists.

Both the Institutionalists and the Post Keynesian also generally agree on the “molecular” concept of economic analysis versus the more “atomistic” concept of the orthodox, Neo-Classicalists. The atomistic concept indicated that the economic observer or participant deals only with economic phenomena and analysis to predict the future and his/her utility maximizing future in it. To them, as it is oft-times said,

“economics is the queen of the Social Sciences!” To the more heterodox Institutional/Post Keynesian, the molecular view is more relevant. In the molecular view, the various parts of the molecule is made up of the presence of and the interactions of various atoms—in social science terms as applied herein, economics, history(hysteresis, for example), sociology, social psychology, psychology. We react as humans and not always rationally; and subsequent events may not allow us to quickly return to “rationality”—whatever that may or may not be under the circumstances! Also, as is well-known in sociology, in a crowd, we may react quite differently than when alone. In a crisis or a series of crisis, the same may be true. In a crowd sociological/psychological mentality of the many prevails. It is this “molecular” concept that we will now analyze in terms of the business cycle and the crisis of the turning points.

The Cycle: “Irrational Exuberance” Versus “Irrational Dissonance”

There are several views of the business cycle and of economic policy relating thereto. Herein, I will select three for the sake of a brief review; and a fourth analysis which will be used to introduce two brief analyses of monetary policy making brief use of the familiar IS/LM analysis. This will lead to a molecular approach, as discussed above, of the evolving financial system from generally the lower turning point to the upper turning point as economics is not enough to understand the process as it goes from exuberance to dissonance.

Perhaps the simplest cycle theory is one based upon “automaticity”. As the downward stage of the cycle materializes, interest rates and prices/wages fall and consumers begin to buy and investors (after inventories decline) invest. This expands the economy until prices/wages/interest rates rise again and consumers begin

to drop out of the markets as do investors and the downturn begins again. There are many assumptions in this theoretical approach, but these are not the point herein.

A second theory of the cycle is more strictly Keynesian. In the strict Keynesian case (especially the textbook story), investment continues until the interest rate in the monetary sector (the cost of loans) equals the marginal efficiency of capital (roughly the rate of return on those borrowed funds). At that point, $i=r$, investment increases stop at that level, the multiplier eventually wears out, and an equilibrium is established. Of course, here I have always wondered why an investor would continue to invest if just beyond the point where $i=r$, $i>r$. This is risk. If so, there is no long lasting equilibrium. The psychology of pessimism may arise and downturn begins as a result (Brazelton, 1980-81).

A third theory herein discussed is exogenous. This could be caused by a demand shock or, as herein, a supply shock. For example, in the late 1970s and early 1980s, “stagflation” occurred. An increase in oil prices (supply shock) drove up costs and, therefore, prices, especially administered prices. Consumers, at first, tried to keep ahead of anticipated inflation by continuing to buy now rather than later, and prices continued to rise. Eventually, as prices continued to rise and real incomes fell, consumers dropped out of the market and employment fell—thus, a fall in employment with a rise in prices to be referred to as a “stagflation”. The consumer changed his/her tendency to consume to begin an attempt to save.

There are some problems with the above. Each analysis looked only at economics. But a question arises. What sociological/psychological phenomena occurred in each of the above? Why when interest rates are low do investors invest when Neo-Classical analysis itself often does not discuss anticipated profit rates or why anticipations change? Profit rates (always merely anticipated until actually

earned in future periods) are often not mentioned, let alone the psychological reasons why the “animal spirits” of investors turn from pessimism to “irrational exuberance” and, later, back to “irrational dissonance”. The exclusion of sociological, historic, psychological influences, especially at the turning points, is not minor, but, rather, is crucial in importance. As George Akerlof, Nobel Prize in Economics, indicated, when it comes to Neo-Classical economic analysis, there is the exclusion of anthropology, sociology and psychology and for him, “I disagree with any rules that limit the nature of the ingredients in economic models” (Akerlof, 2003, p.2). We shall return to this concept below.

A fourth analysis of the cycle will be used herein to demonstrate more explicitly the problems that Akerlof introduced above—the “financial instability hypothesis” of Hyman Minsky (Minsky, 1977, 1982). In Minsky, we have at the lower turning point, investors beginning to invest again. The investors, however, remembering the preceding recession, are conservative investors—hedge investors. These investors are relatively non-risk investors; but as the economy continues upwards, investors become more speculative and cash flows from current output becomes insufficient to pay off loans. As the cycle continues, lenders and borrowers (investors) become even more speculative and confident as overdrafts continue (Peterson and Estenson, 1996, p. 689), but the borrower is beginning to need to borrow to pay-off past loans; and increased leveraging begins which increases risk. Eventually, the increased leveraging and risk increase catches up to the lenders and borrowers and “irrational exuberance” turns into panic (as in past U.S. history) and “irrational dissonance” becomes the reality. But why?

Part of the answer can be seen in the general analysis of the Minsky analysis itself. Minsky, as he often stated, believed that economic analysis worked in

three time periods simultaneously—the past, the present, and the future. Present investment decisions are based upon past information; but present decisions are also based upon anticipated, future income flows. These anticipated, future income flows must (1) not only absorb the increases in goods coming from the current investment output; but (2) also absorb them at a cost covering price. When this fails to materialize, the downward cycle begins, “Irrational exuberance” becomes “irrational dissonance” (Minsky 1977, 1982).

Like “irrational exuberance”, “irrational dissonance” involves multiplier effects upon the economy. It also involves historic, sociological, psychological phenomena. These, too, can have a multiplier effect upon the socio-economic system. The sociological “contagion” triggered by the economic crisis begins to spread throughout the system (Bull, 2003). The “contagion” concept is based upon sociological theory, but it is analogous to an economic multiplier as it spreads—like a virus—throughout the system—positively in an expansion, negatively in a contraction. Economics does sometimes speak of the “psychology” of markets, but those references are usually devoid of sociological or psychological knowledge or the realization that such resultant contagions can have multiple, spreading effects throughout the socio-economic system. Furthermore, these effects may involve the concept of “non-ergodicity” and “hysteresis” discussed above. There is more than the “atomistic” concept of economic concept herein; there is a “molecular” concept that demands to be recognized and analyzed.

At this point, one may add an extension to the Minsky analysis herein—namely the analysis of Randall Wray (Wray, 1990, 1992, 1998) concerning the money supply and its endogeneity. That is, if the Federal Reserve wished to maintain a specific interest rate, and if the interest rate varied downward in the

market, the Fed would have to sell bonds on the open market to drive interest rates up to the specified level desired and vice versa—typical countercyclical monetary policy. Thus, the money supply must vary to maintain the preferred rate of interest—endogeneity. Thus, the LM schedule would be horizontal or possibly slightly upward sloping to compensate for risk as lending/borrowing (especially in terms of Akerlof’s “asymmetric information) continues to finally bring (even without a shortage of money) a crisis as the social psychology, et al, of declining profits and/or rising expectations of trouble or some outside shock turns “irrational exuberance” into “irrational dissonance”. Herein, the crisis in financial markets depends upon more than monetary factors. The crisis—cause and effect—is molecular, interdependent, and subject to the spread effects of sociological contagion.

The concept of a “molecular” view of economics is, of course, not new. It has been and is a vital part of Institutional (Evolutionary) analysis. The molecular concept deals not only with the socio-economic system; it also involves individuals. An individual—drawn into a social group—may react quite differently in the group than he/she would as an individual, a problem with the individual orientation of utility analysis. For example, Lord Keynes indicated that if an individual in a contest to pick the best picture in a beauty contest “...had to pick, not those pictures which he himself finds prettiest, but those which he thinks likely to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view” a sociological, psychological problem of choice arises. In an analogy of the quote to the stock market, Keynes continues, “...we have reached the third degree where we devote our intelligence to anticipating what average opinion expects average opinion to be. And there are some, I believe, who practice the fourth, the fifth and higher degrees” (Keynes, 1936, p. 156). In such a socio-economic,

psychological reality, expectations, uncertainty and the sociological/psychological, historic basis of such decisions are not rationally to be overlooked. Once again, as Akerlof indicates, "...neo-classical models do not make assumptions derived from psychology, anthropology, sociology. I disagree with any rules that limit the nature of those ingredients in economic models" (Akerlof, 2001, P.1). Also, Akerlof points out, there is in economics the problem of "asymmetric information" which complicates the financial process, increases uncertainty, and effects the path to and the resultant "equilibrium" (Rosser, 1993); as well as the sociological/psychological reactions in and to the process.

Further, for our study herein, such "socio-economists" as Michael Radzicki, indicated that "...the values, rules, customs, habits, incentives, moral and technical,...and other psychological decision-making factors of a particular socio-economic system determine the goals that are sought and the speed at which they are pursued..." and "...the very act of pursuing the goals generated the feedback effects that modify the institutional structure" (Radzicki, 1988, p. 689f)

Lastly, as Paul Ormerod suggests, as we give up the mechanistic, linear behavior of Neo-Classical orthodoxy, we enter the more unpredictable world of complexity where "...society is more than the sum of its individual parts" (Ormerod, 1997, p.222). Thus, we have the possibility of economic multipliers, sociological contagions, non-ergodicity, hysteresis, and asymmetric information—all in a non-atomistic, molecular world.

Conclusion

The above has stressed the general concepts of major, selected parts of Institutional (Evolutionary) economic analysis and Post Keynesian economic analysis in order to show not only these similarities, but how these similarities can be analyzed

in terms of business cycle phenomena in terms of the molecular, inter-disciplinary, inter-dependent view of economic analysis. It has indicated that the Neo-Classical version of “economic man” and economic analysis is too atomistic and restrictive to grasp what is occurring in the “on-going” reality of the socio-economic system with its historical, sociological, psychological interrelationships. It is not a world of “ceteris paribus” but one of “mutatis mutandis” in which the system is open to many influences, anticipated and unanticipated.

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