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The Economic Crisis is a Crisis for Economic Theory

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Abstract

This article examines, in the light of recent events, the origins of the difficulties that current macroeconomic models have in encompassing the sort of sudden crisis which we are currently observing. The reasons for this are partly due to fundamental problems with the underlying General Equilibrium theory and partly to the unrealistic assumptions on which most financial models are based. What is common to the two is that systematic warnings over more than a century in the case of finance and over 30 years in the case of equilibrium theory have been ignored and we have persisted with models which are both unsound theoretically and incompatible with the data. It is suggested that we drop the unrealistic individual basis for aggregate behaviour and the even more unreasonable assumption that the aggregate behaves like such a 'rational' individual. We should rather analyse the economy as a complex adaptive system, and take the network structure that governs interaction into account. Models that do this, of which two examples are given, unlike standard macroeconomic models, may at least enable us to envisage major 'phase transitions' in the economy even if we are unlikely to be able to forecast the timing of their onset. (JEL codes: B22, D84, D85, E10, E44)

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