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What Should Economists Do?

The role of economists should be to prevent, or to at least lessen, the disastrous effects of market crashes on the economy. Market downturns should usually be allowed to occur without interference, but we should understand the economic consequences of fiscal policy well enough to prevent disasters like the Great Depression and the most recent Great Recession. Normal business cycles are a healthy part of the economy because slight downturns create opportunities for the entrepreneur. There is great value in studying the actions of the entrepreneur because they help us to understand how information is processed to fuel exchange in the market. If there is any value at all in studying economic theory, it is in applying economic principles to markets in the real world. The most perfect computational models do no good if we do not understand the catallactics of exchange and cannot prevent catastrophic market failures. Economics should not be so much about equilibrium, but about catallactics. We need models that help us explain markets and prices as they actually are rather than as mathematics says they should be. By studying the exchanges that lead to the emergence of market prices, we can come to understand the flow of information and incentives that are that lead to exchange. This paper will discuss some popular assumptions of equilibrium economic models and why those assumptions severely limit the usefulness of their models. I will also explain why the Austrian market-process views are more useful to us than equilibrium models that view the economy as a state.

Economists often make the assumption that all information is readily available to everyone. They say that it is "given" in their models that everyone has access to all the information in the market. The fact is that such information is not always so easily found. One of the major flaws of popular economic models is that they offer no insight or explanation on how information is disseminated. According to Hayek, “To assume all the knowledge to be given to a single mind in the same manner in which we assume it to be given to us as the explaining economists is to assume the problem away and to disregard everything that is important and significant in the real world” @Hayek1945. He goes on to explain that each person has some unique knowledge that gives him an advantage over others in the market @Hayek1945. Economies function because each person leverages their particular knowledge and set of skills to find arbitrage opportunities.

If we aggregate all of those people into one whole, then everything averages out into a nice model that tells us nothing about how exchanges are taking place. If economics is the study of market forces, then equilibrium economists are completely ignoring the process that they should be focusing on. Economic equilibrium models are useful to describe a state toward which the market tends to shift, but it is important to understand that markets are in a constant state of disequilibrium. Were it not so, then there would never be any change in behavior by any market participants. According to Stiglitz, “Equilibrium is a state where no economic agents have an incentive to change their behavior. . . the equality of demand and supply should not be taken as a definition of equilibrium, but rather as a consequence following from more primitive behavioral postulates” @stiglitz1987causes. Equilibrium would mean that all plans of each economic actor are in sync and can be executed compatibly. However, the economy is actually filled with economic agents that have conflicting plans, and the ones with the best plans tend to edge out the others.

As Thomsen explained, “the defining characteristic of equilibrium is not the equality of quantities supplied and demanded but, instead, the knowledge (and exploitation) by the trading agents of all profitable opportunities, that is, ‘perfect’ knowledge” @thomsen1992prices. Equilibrium then can only occur in an economy where each economic actor has a perfect knowledge of all arbitrage opportunities that are available and has already done everything he can to exploit them. Therefore an equilibrium model of the economy completely ignores the exchange of information and does nothing to explain the knowledge problem. Many economists choose to ignore the study of disequilibrium because they assume that all disequilibrium situations will eventually become equilibrium situations and then they can explain them using their models @thomsen1992prices. However they are missing what I believe is the most important part of economics, which is explaining how the market process takes disequilibrium situations and pushes them toward equilibrium.

One of the best ways to study this process of exchange in markets is to study the entrepreneur. An entrepreneur is someone who is able to discover and profit from previously unknown arbitrage opportunities @thomsen1992prices. That means they either find a new way to exploit an existing good or create and distribute a new product.

Buchanan

* Economists should focus on studying exchange rather than choice

The only thing that economists can actually do to change markets is to manipulate the incentives in the marketplace by changing laws or fiscal policies. The Federal Reserve employs over 300 individuals with Ph.D.’s in economics, and yet they still cannot prevent major financial crises from occurring. If all we do is build complex mathematical models that do little to explain the real world, then economics as a social science provides little value. Some of the current methodologies in neoclassical economics are preventing economists from reaching their potential.

One of the greatest blunders economists make in their mathematical models is assuming that market prices are normally distributed. Bayesian statistics is more adept at modeling the real world than classical methods because it attempts to use current knowledge to predict the future without forcing the data to fit a normal distribution. One of the most important jobs of economists is to predict when disastrous events will occur in markets, and to understand the incentives of the individual players in the market well enough to know what steps should be taken to avert such crises.

The Neo-Keynesian dynamic stochastic general equilibrium (DSGE) model has some fatal flaws that severely limit its usefulness in representing the real world. First, it assumes that people behave predictably and rationally when in reality they do not (Rickards 2016). It also claims that local equilibria can be aggregated into a complete whole without loss of important information. Hayek explains that this is not the case. The economy is driven by the use of information by individuals whose circumstances are unique to the time and place (Hayek). The third and most fatal flaw of the DSGE model is that it assumes the market prices to fall in a normal distribution. Normal distributions are not a good representation of prices because they ignore the possibility of extreme market events such as Black Monday and Black Thursday. According to a normally distributed model, such events should only occur every 40 million years, yet we have had several such events in the past 100 years. Market prices are much more accurately represented by a Paretian distribution.

Chapter2 : @thomsen1992prices

Hayeks use of knowledge in society: @Hayek1945

@stiglitz1987causes

Road to ruin: @rickards2016road