

International Trade and Monetary Systems

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2015

Mainstream, Orthodox

- ▶ Beginning with **Adam Smith** and **David Ricardo**, economists have developed economic models that support the hypothesis of a **positive relationship between international economic integration and human well being**.
- ▶ Textbooks in international economics frame their analysis around these models, which we will refer to as mainstream, or orthodox, international economics.
- ▶ Many people remain **unconvinced** by economists' theoretical arguments, however.
- ▶ The large gap between most economists' active advocacy of policies to promote international economic integration and the general public's distrust is driven by general perceptions of how international economic integration affects human society.

Orthodoxy

- ▶ The prefix ortho in ancient Greek means Right or Correct.
- ▶ The word doxy refers to a doctrine, a framework of analysis, or what many social scientists would call a paradigm.
- ▶ Orthodoxy thus suggests its set of ideas, perspectives, and models are the Right way to go about analyzing the economy, and that other perspectives are Wrong or Incorrect.

The Dominant Paradigm

- ▶ The orthodox model of trade is the neoclassical Heckscher-Ohlin model, developed in the 1920s.
- ▶ Financial economics has adopted a neoclassical paradigm that assumes financial markets remain stable under all circumstances.
- ▶ Immigration models are exclusively neoclassical, the lingua-franca of the field of labor economics where immigration is most often discussed.
- ▶ International investment is also analyzed within neoclassical models, in which capital is allocated so that marginal returns equal marginal costs.

The History of Neoclassical Economic Thought

- ▶ The Neoclassicals have developed an elaborate modeling structure that supports Adam Smith's idea that the Invisible hand operates through free markets to channel self-interest into an optimal level of human welfare.
- ▶ Neoclassical analysis is marginalist in the sense that it consists of optimization exercises whose solutions are characterized by the coincidence of marginal costs and benefits.
- ▶ Another principal feature of neoclassical thinking is that it is scientifically reductionist, viewing the economy from the static perspective of a fixed set of resources among which choices must be made.

The History of Neoclassical Economic Thought

- ▶ Neoclassical economists did not focus exclusively on microeconomics; they sought aggregate models, too.
- ▶ Neoclassical analysis followed Walras in seeking an aggregate model systemically links individual consumers, workers, producers, bankers, and investors in a whole system.
- ▶ Neoclassical economists sought microfoundations for macroeconomics, which are logically consistent models of individual consumers and producers that logically explain macroeconomic outcomes.
- ▶ It took very strong simplifying assumptions to create macroeconomic models that are logically compatible with models of individual and firm behavior.

The History of Neoclassical Economic Thought

- ▶ Labor markets were modeled as competitive markets where labor was paid its marginal product.
- ▶ Producers were assumed to always face rising costs, so that perfect competition could be maintained.
- ▶ The Coase theorem was accepted, which let economists assume away externalities.
- ▶ Fama's model of efficient markets assumed all available information was always built into asset prices.
- ▶ Friedman hypothesized that speculation always stabilizes financial markets.
- ▶ Jensen and Meckling depicted managers of private firms as faithful servants to the firm's stockholders.

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The History of Neoclassical Economic Thought

- ▶ Muth's assumption of rational expectations were applied to all economic actors.
- ▶ Arrow and Debreu found a way around the problem of uncertainty by assuming financial markets only face risk defined by known stable probability distributions.
- ▶ They then eliminated even that risk by assuming competitive markets in contingent commodities.
- ▶ Arrow and Debreu's contingent markets are a theoretical fantasy that hides the complexity of risk and uncertainty.
- ▶ John Maynard Keynes provides a more realistic assessment of long-term uncertainty and risk.
- ▶ The neoclassical welfare function is stable and relates goods and services consumed to individual welfare, which is not affected by others' welfare or social factors.

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Neoclassical Paradigm & Free Trade

- ▶ (International) economists most often embrace the neoclassical paradigm.
- ▶ Models based on the neoclassical assumptions inevitably predict that free trade, unrestricted international investment, unregulated international finance, and unrestricted immigration are welfare maximizing.
- ▶ (International) economists seem to have become reluctant to extend the models and focus on broader issues, perhaps for fear of undermining the pro-international economic integration culture of the field.
- ▶ (The field of international) economics has created a culture that takes the neoclassical models conclusions as truth.

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A Variety of Perspectives

- ▶ We take a heterodox approach to international economics.
- ▶ We cover most of the same topics and issues covered in mainstream international economics courses, but we will use a variety of models from many different paradigms.
- ▶ Heterodox economists use models, too, but unlike mainstream economists, heterodox economists resist relying on just one model or one set of related models generated under one uniform set of assumptions.
- ▶ Next week we discuss the heterodox approach in more detail.

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Heterodoxy

- ▶ The prefix hetero in ancient Greek means other or different.
- ▶ The word doxy refers to a doctrine, a framework of analysis, or what many social scientists would call a paradigm.
- ▶ Heterodoxy suggests a set of ideas, perspectives, and models that are in some way different from the orthodox paradigm.
- ▶ The orthodox paradigm in economics is the neoclassical paradigm.
- ▶ Heterodox economists are not necessarily anti-neoclassical, but they do firmly reject the idea that economic phenomena can be accurately understood and analyzed entirely from within the neoclassical paradigm.

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Holism: A Central Principle of Heterodoxy

- ▶ Heterodox economics embraces holism and the scientific method, as every social science should.
- ▶ It is careful to distinguish its holistic scientific approach from the scientific reductionism of orthodox neoclassical economics.
- ▶ Heterodox economics seeks to identify and actively compensate for the biases inherent in any one paradigm, which enables scientific honesty in the study of the complexity and uncertainty of human existence.
- ▶ The holistic approach to understanding, which is the simultaneous focus on the parts and the systemic interactions of those parts, has been pursued in many fields.

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Holism

- ▶ The sociologist Emile Durkheim argued that society is not a collection of individuals; rather, it is a community that can take on many different forms, depending on how a group of individuals organizes itself.
- ▶ Economist Kenneth Boulding described holism as links between the specific that has no meaning and the general that has no content.
- ▶ In addition to its systemic focus, holism views human existence across disciplinary boundaries.
- ▶ Holism also views events as part of an evolving dynamic system that links past, current, and future events.
- ▶ In sum, holism implies a systemic approach that seeks inter-disciplinary perspectives and views events as part of an evolutionary, ever-changing process.

Scientific Holism

- ▶ Scientific reductionism assumes that we can understand the whole by learning about its parts, one part at a time, and that the whole is the predictable sum of its parts.
- ▶ Holistic scientists, in contrast, accept that in a complex process or system, one must understand not just the parts, but also how the parts interact.
- ▶ Because the human activity is a component of a complex dynamic process, scientific reductionism is clearly not scientific because it ignores how interactions between the components of a system determine the outcomes of the overall system.

Steps of the Scientific Method

1. Carefully and accurately observe some phenomenon or fact; this constitutes a scientific observation.
2. Use reason to invent a hypothesis, which is a carefully stated or presented relationship or idea that accurately and logically explains the facts you observe.
3. Confront the hypothesis with real world outcomes or perform experiments to generate outcomes that can be compared to the hypothesis' predicted outcomes.
4. Perform many experiments or observe large amounts of real world outcomes under a variety of circumstances in order to avoid conclusions driven by unseen forces not taken into consideration in your hypothesis, observations, and experiments.

Steps of the Scientific Method

5. Record everything you do and observe, so that others can see exactly how your hypothesis was tested.
6. Carefully examine whether all the observed outcomes consistently conform with your hypothesis.
7. If these tests of your hypothesis reveal that the real world outcomes or experimental outcomes are not consistent with your hypothesis, modify your hypothesis and return to step 2.
8. If your experiments, observations, or other objective tests consistently confirm your hypothesis, your hypothesis becomes a theory (a confirmed hypothesis). The scientist must publish all results, accompanied by all the details of the tests that confirm the hypothesis so that others can replicate the experiments and confirm the methods and results.

The Scientific Method

- ▶ The scientific method naturally demands that we take a holistic approach when we analyze complex systems such as the global economy and the social and natural systems within which humans carry out economic activities.
- ▶ Science and holism are fully compatible, and their joint application can be termed holistic science.
- ▶ In general, holistic science is the scientific study of complex systems.

The Ideas of Heterodox Economics

- ▶ Heterodox economists are not a homogeneous group.
- ▶ Heterodoxy implies respect for alternative paradigms to study economic issues and alternative directions in their research and analysis.
- ▶ There are some ideas that are embraced by many heterodox economists, however, and these could be called fundamental ideas of heterodoxy.
- ▶ These ideas are often interrelated, which is understandable given the complexity of the social phenomena and the holistic approach that heterodox economists follow.

Humans simultaneously live in economic, social, and natural spheres

The Ideas of Heterodox Economics

- ▶ Social scientists are constrained and influenced by their culture.
- ▶ We must try to distinguish our biases and, therefore, mitigate and compensate for them.
- ▶ By recognizing the likelihood of violating the ideal scientific method but finding ways to compensate and mitigate cultural biases, the spirit of the scientific method can be maintained.
- ▶ The orthodox neoclassical approach of pretending to be objective while using models that ignore cultural influences and the social and natural spheres of existence constitutes a serious violation of the scientific method.

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Culture influences economic thought

The Ideas of Heterodox Economics

- ▶ The history of economic thought is intimately related to the evolution of human culture.
- ▶ Economics is as much a result of the economic and social forces it tries to explain as it is an objective explanation of economic phenomena.
- ▶ Heterodox economists recognize that culture is a collective phenomenon, widely held and reinforced views and perspectives that are imposed on the collective of people that we call society.
- ▶ Culture does not fit into the methodological individualism adopted by neoclassical economics.

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The analysis of economic activity requires an interdisciplinary approach

The Ideas of Heterodox Economics

- ▶ Since economic activity occurs within complex social and natural systems, economists must take advantage of the knowledge base in other fields of study.
- ▶ Findings from psychology should shape economists' models of human behavior and their welfare function.
- ▶ Political science has much to tell economists about how they should study economic policy.
- ▶ The field of ecology can contribute greatly to the accurate estimation of opportunity costs and cost functions.
- ▶ Sociology can help economists understand social behavior as more than the sum of individual behaviors.

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Economists must know the history of economic thought

The Ideas of Heterodox Economics

- ▶ Knowledge grows according to a combinatoric process in which new ideas emerge from combinations of earlier ideas.
- ▶ Today's focus on only the neoclassical paradigm has caused economists and their students to lose valuable contributions to our economic understanding.
- ▶ Today's orthodox economists ignore alternative paradigms that provide valuable perspectives for understanding our complex modern economic environment.

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Complexity must be respected, not assumed away

The Ideas of Heterodox Economics

- ▶ Economic analysis and economic policy must recognize that the economic system and the combination of the economic, social, and natural systems are almost certainly not linear.
- ▶ Multiple equilibria are possible.
- ▶ Complexity requires policy approaches that include the precautionary principle, build flexibility into policies, and accept the need for continual experimentation.
- ▶ As circumstances change, new initiatives to deal with unanticipated problems and opportunities will be needed.

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Human well-being does not depend on material goods and services alone

The Ideas of Heterodox Economics

- ▶ Psychology, neurology, happiness studies, and behavioral economics have all demonstrated that human welfare is not accurately represented by the neoclassical aggregate welfare function.
- ▶ Social welfare is not the sum of individual welfare functions.
- ▶ People value their social status, the company of others, their overall social environment.
- ▶ People also value their relationship with the natural environment.
- ▶ Individuals in most circumstances value their relative income and social status much more than gains in absolute material wealth.

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The bottom line in economic analysis is not output or per capita GDP

The Ideas of Heterodox Economics

- ▶ While they do not say that measures of per capita income are completely useless, heterodox economists do argue that relying on such a measure alone distorts economic analysis.
- ▶ Increases in per capita real GDP almost always accompany large shifts in economic activity and resource allocation.
- ▶ For example, when international trade, international investment, and immigration are part of the growth process, there are substantial changes in income distribution and, therefore, individual and group welfare.

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Human society continually evolves; it is not static

The Ideas of Heterodox Economics

- ▶ All economic policies and the resulting changes in specific economic outcomes generate feedback and reactions throughout the economy, society, and the natural environment.
- ▶ These outcomes and feedbacks operate dynamically over time to generate a string of subsequent economic events.
- ▶ An accurate assessment of economic policies must estimate the long-run dynamic path that such policies put the economy on.

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Social and economic institutions are fundamental to economic outcomes

The Ideas of Heterodox Economics

- ▶ A society's formal and informal institutions shape individual and firm behavior.
- ▶ This is why heterodox economists often favor inter-disciplinary analysis in order to fully understand society's institutions.
- ▶ Heterodox economists are commonly concerned with the dynamics of social institutions that determine economic outcomes.
- ▶ Especially important for economic outcomes are institutional phenomena such as racial and gender discrimination, cultural oppression, and political power structures.

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Feminist perspectives contribute greatly to economic understanding

The Ideas of Heterodox Economics

- ▶ Economics seldom pays attention to how economic activity and policies affect people with distinct positions in human society.
- ▶ The consequences of economic change are often very different depending on one's economic and social positions.
- ▶ Gender, race, class, ethnic identity, and other personal characteristics are important for determining who bears the costs and benefits of international economic integration.
- ▶ Mainstream economics usually assumes all individuals are Representative agents. In other words, identical.
- ▶ Feminist economists have shown that this clearly is not the case.

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Environmental consequences of economic activity must be internalized

The Ideas of Heterodox Economics

- ▶ Mainstream economics, with its focus on market activity, has largely failed to recognize and analyze policies to deal with the environmental consequences of economic activity.
- ▶ Mainstream economics has often designated the role of the natural environment on economic activity as a non-economic issue.
- ▶ Nor has orthodox economics paid much attention to economic activity's effect on the natural environment.
- ▶ Heterodox economists are more likely to build the natural environment into their analysis.

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People are both individuals and social beings

The Ideas of Heterodox Economics

- ▶ Neoclassical economics' assumption that there are no societies, only individuals does not at all reflect actual observed human behavior.
- ▶ Heterodox economists recognize the overwhelming evidence that people are social beings, and social institutions and culture are dominant factors in human economic behavior.
- ▶ Heterodox economics also accepts the need for government to carry out collective actions in a complex society; efficient individual behavior, by itself, cannot deal with holistic economic and social issues.

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Mathematics is useful, but not required in economic analysis

The Ideas of Heterodox Economics

- ▶ Heterodox economists recognize that economic models can be stated in mathematical form.
- ▶ However, mathematics introduces more biases into economic thinking because mathematics is not nearly as powerful as mainstream economists suggest.
- ▶ Neoclassical economists have had to limit their dynamic analyses to a small set of very simplistic models that can be solved mathematically.
- ▶ Heterodox economists recognize that there are many ways to communicate and store information, with mathematics but one medium.
- ▶ Complex ideas are often better communicated in words rather than with mathematics.

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Make selective use of multiple models rather than relying on one paradigm

The Ideas of Heterodox Economics

- ▶ Since all models are simplifications of reality, and we only very partially understand reality, modeling inevitably introduces inaccuracies into economic analysis.
- ▶ Examining an issue using a variety of models can alert us to these inaccuracies.
- ▶ Heterodoxy recommends the use of models whose assumptions most closely parallel the phenomenon and situation being analyzed.
- ▶ The use of multiple models with diverse assumptions permits us to judge the robustness of the conclusions and predictions.

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The fallacy of composition distorts human thinking

The Ideas of Heterodox Economics

- ▶ The choices that improve an individual's well being, all other things equal, may not improve anyone's welfare if everyone makes the same decision.
- ▶ For example, while personal saving is good for every individual, but if everyone saves more, the economy may end up with higher unemployment and lower real savings in the long run.
- ▶ In international economics, it is not necessarily true that cheap imports improve national well being even though at the time of purchase an individual definitely feels better off buying a lower priced import rather than a more expensive domestic equivalent.

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Small government is not generally better than a larger government

The Ideas of Heterodox Economics

- ▶ In human society, there is a need for collective decisions.
- ▶ Especially in a complex modern society, individual action cannot deal with all problems and opportunities.
- ▶ Individuals seem to have little or no desire to alter their behavior to deal with major problems like national defense, global warming, the massive extinction of living species, a global financial crisis, etc.
- ▶ Holistic heterodox economists are, therefore, not as likely as orthodox neoclassical economists to favor relying on individual actions over collective government action to deal with economic problems.

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Economic transactions do not take place only in markets

The Ideas of Heterodox Economics

- ▶ Of all the interactions between humans over the course of a day, very few actually occur in organized markets.
- ▶ Most interactions occur informally under a variety of social norms, family customs, acquired routines, mandated rules and regulations, legal parameters, corporate structures, business procedures, and other cultural habits that guide human behavior.
- ▶ Those markets that do exist are seldom competitive.
- ▶ Heterodox economics seeks to understand transactions between parties with different levels of market power, as well as the exploitation, oppression, and unequal outcomes that tend to accompany unequal market power.

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Economic policy must address the distribution of income

The Ideas of Heterodox Economics

- ▶ People's satisfaction with life depends on social and economic status.
- ▶ Therefore, relative income and employment are the main determinants of human well being, certainly in medium and high income countries where basic needs are largely satisfied.
- ▶ It is impossible to judge economic outcomes and policies without explicitly taking into consideration the distribution of the gains and losses associated with economic change and increased international interactions.

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No man is an island

The Ideas of Heterodox Economics

- ▶ Human interdependence as the critical concept for understanding international economics.
- ▶ The expansion of international trade, international investment, international finance, and immigration offers many benefits.
- ▶ However, the sudden expansion of human interdependence from small groups to the entire world over a period of just 10,000 years represents a huge increase in the complexity of human economic and social organization.
- ▶ The heterodox approach and its interdisciplinary perspectives offers a much more realistic framework of analysis for understanding the welfare implications of the rise in the complexity of human existence, in which all the islands are connected and interdependent.

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Heterodox Economics and Economic Policy

- ▶ It is in the area of economic policy that the different perspectives of orthodox and heterodox economics are most apparent.
- ▶ Heterodox economists' policy prescriptions are usually much less specific than the policy prescriptions suggested by orthodox economists.
- ▶ Mainstream economics seeks to minimize indeterminacy and flexibility in its prescribed policies.
- ▶ The true state of uncertainty makes a mockery of deterministic neoclassical calculations; heterodox economists usually accept ranges of possible outcomes.
- ▶ In recognition of the uncertainty of what will actually come to pass, they are likely to invoke the precautionary principle in a case such as this where some of the possible outcomes are truly catastrophic.

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