

Arestis, Philip; Ferreiro, Jesus

Article

Special Issue: Micro-foundations of macroeconomics: how important are they?

European Journal of Economics and Economic Policies: Intervention (EJEEP)

Provided in Cooperation with:

Edward Elgar Publishing

Suggested Citation: Arestis, Philip; Ferreiro, Jesus (2014) : Special Issue: Micro-foundations of macroeconomics: how important are they?, European Journal of Economics and Economic Policies: Intervention (EJEEP), ISSN 2052-7772, Edward Elgar Publishing, Cheltenham, Vol. 11, Iss. 1, pp. 50-52,
<https://doi.org/10.4337/ejeep.2014.01.04>

This Version is available at:

<https://hdl.handle.net/10419/277289>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.



<https://creativecommons.org/licenses/by/4.0/>

Special Issue: Micro-foundations of macroeconomics: how important are they?

Editorial to the Special Issue

Philip Arestis

Cambridge Centre for Economic and Public Policy, Department of Land Economy, University of Cambridge, UK, and Department of Applied Economics V, University of the Basque Country (UPV/EHU), Bilbao, Spain

Jesus Ferreiro

Department of Applied Economics V, University of the Basque Country (UPV/EHU), Bilbao, Spain

The Department of Applied Economics V of the University of the Basque Country (UPV/EHU) and the Cambridge Centre for Economic and Public Policy, Department of Land Economy of the University of Cambridge, organized the 10th International Conference entitled *Developments in Economic Theory and Policy*. The Conference took place in Bilbao (Spain) on 27 and 28 June 2013. In this issue of the *European Journal of Economics and Economic Policies: Intervention (EJEEP)*, the papers of the special session, ‘Micro-foundations of macroeconomics: how important are they?’ are published.

The first contribution to this special issue, entitled ‘On economic paradigms, rhetoric and the micro-foundations of macroeconomics’, is by John McCombie and Ioana Negru. The authors in their contribution are concerned with the current crises in macroeconomic theory and policy, and address, from a methodological standpoint, why such controversies have repeatedly occurred since the Keynesian revolution. They argue that the micro-foundations programme that is seen by the majority of economists as the *sine qua non* of modern macroeconomics can be understood as advancing a reductionist methodology, in its ‘strong’ rather than ‘weak’ form. Weak reductionism involves interpreting aggregate relationships intuitively in terms of those of the individual, such as Keynes’s ‘fundamental psychological law of consumption’. It is an inevitable part of macroeconomics. Strong reductionism, however, involves the explicit use of the representative agent model, based on optimization behaviour. Under this approach, the economy is taken to be merely a blown-up version of this model. By these means, the approach avoids, rather than solves, the severe aggregation problems concerning both consumers’ preferences and firms’ production technology. It is argued that this reductionist methodology applied to macroeconomics is deeply flawed. It encounters various insurmountable problems, including the impossibility of proving the existence of a stable and unique equilibrium; the challenges in aggregating production and utility functions; the fallacy of composition; and the consideration of atomic isolated individuals, devoid of social context and the different institutions which shape their disparate, albeit optimizing, behaviour. The persistence of competing macroeconomic schools of thought, such as the New Neoclassical Synthesis and the Post Keynesian school, is analysed in terms of Kuhn’s concept of the paradigm. The ‘paradigmatic pseudo-assumptions’ (paradigm core assumptions that are deemed untestable by fiat) and the existence of incommensurability means that paradigm choice is an essentially subjective matter, especially given inherent inconclusiveness of econometric testing. One possible avenue to resolve this conundrum is the use of rhetoric. McCloskey, who has done most to promote this approach, argues that this will be

sufficient to ensure that progress occurs in economics. Unfortunately, experience suggests that this view is much too sanguine. It is concluded that it is unlikely that the problems for the New Neoclassical Synthesis thrown up by the 2007 subprime crisis are likely to have a major impact on the way neoclassical macroeconomists continue to view the subject.

Thanos Skouras and Yiannis Kitromilides, in their contribution entitled 'The irresistible charm of the micro-foundations dogma or the overwhelming force of the discipline's hard core?', argue that the 'Micro-foundations' project in economics encapsulates a metaphor, which ordains the relationship between microeconomics and macroeconomics. According to the metaphor, microeconomics constitutes the foundations of macroeconomics. It follows that macroeconomic theory without microeconomic foundations is unreliable and defective. This project is strongly supported by the considerable force of what Lakatos calls the discipline's 'hard core'. It is particularly enhanced if it is seen as a way of giving precedence to microeconomics in unifying economic theory rather than as requiring that all macroeconomic propositions are reduced to or derived from microeconomic ones. Given that the 'hard core' has an essentially micro-theoretic nature, questioning the Micro-foundations project is tantamount to confronting the 'hard core'. The two most fundamental tenets of the 'hard core' are the maximization of utility and maximization of profit. The paper examines these two fundamental tenets and argues they suffer from serious weaknesses. Maximization of utility, which is contradicted by experimental and other empirical evidence, is neither necessary nor sufficient for establishing the 'law' of demand. Similarly profit maximization is also found wanting on both theoretical and empirical grounds. This is the case for large corporations under managerial control and small owner-run firms. These failings undermine confidence in the relevance and robustness of 'positive' microeconomic theory. Privileging micro over macro theory does not ensure sound foundations and the Micro-foundations project makes little sense. Consequently, the search for consistency between microeconomics and macroeconomics should best be pursued in terms of a 'bridge' rather than a 'foundations' metaphor.

Jagjit Chadha, in his contribution entitled 'Financial frictions and macroeconomic models: a tour d'horizon', assesses recent developments in micro-founded macro models, provides some pointers for the micro-founded agenda, and makes a case for persisting with the microeconomic foundations of macroeconomics. Even though the baseline sticky-price micro-founded model yielded a number of insights for monetary policymakers and helped frame the operational pursuit of price stability, it became clear during the global financial crisis that it could not analyse the implications arising from easy money and expanding credit and balance sheets. There has, therefore, been a promising search for the micro-founded workhorse model that incorporates financial frictions, but this is still in its early stages. One of the identified problems is the relaxation or otherwise of financial frictions that affects both potential output and demand. This contribution outlines a number of examples that use mechanisms such as commercial-bank-supplied inside money, a loans production function, and preferences for riskless assets, as well as some heterogeneity between savers and borrowers. In each case, financial questions are shown to change the terms of trade for the policymaker. Specifically, it is generally shown that the case for the manipulation of central bank liabilities, or outside money, is made more important when financial frictions are shown to impact in important ways on the economy. The ongoing global financial crisis poses a number of questions about both the fundamental causes of business cycle fluctuations and the extent to which monetary-fiscal and debt management policies should be jointly determined.

In 'Rethinking the micro-foundations of macroeconomics: insights from behavioural economics', Michelle Baddeley explores the potential for unifying behavioural economics and microfounded macroeconomics. Behavioural influences such as cognitive bias, time

inconsistency, social influences and emotional factors undermine standard macroeconomic models. Macroeconomists who do attempt to embed behavioural factors into their models often focus on Keynes's animal spirits as a proxy for behavioural influences. The problem with these animal spirit models is that they either fail to capture the essence of the socio-psychological forces affecting the macroeconomy or they treat animal spirits as an exogenous variable – in much the same way as technological change is treated as an exogenous variable in Solow's growth theory. Michelle Baddeley's innovation is to suggest ways in which animal spirits and other behavioural factors can be embedded into macroeconomic models. Potentially these influences can be introduced into a standard type of micro-founded macroeconomic model by endogenizing discount factors and specifying them as a function, in part, of animal spirits and other socio-psychological influences. Theoretical and empirical challenges remain however: a microfounded model based on behavioural principles does not solve the aggregation problem; animal spirits are hard to define and even harder to quantify. For these reasons, a standard econometric approach to estimating animal spirits models will have limitations, although agent-based and structural modelling strategies may provide a useful direction for empirical research. In terms of policy implications, an animal spirits model that allows a role for social and political mood promises to offer new insights into managing the macroeconomy.

In the final paper of this special issue, entitled 'Post-Keynesian stock-flow models after the subprime crisis: the need for micro-foundations', Photis Lysandrou argues that the subprime crisis has exposed a flaw in post-Keynesian stock-flow models, namely their concession to mainstream theory that financial markets obey a price clearing rule. This conclusion is prompted by evidence that the rapid expansion of the toxic securities that triggered the financial crisis was chiefly motivated by attempts to satisfy the demand for yield spilling over from the other US debt markets. This evidence is embarrassing for post-Keynesian stock-flow models because in conceding that the financial markets always clear through price adjustments they clearly cannot admit the possibility of excess demand pressure spilling over from one financial market to another. Lysandrou goes on to argue that the root cause of this flaw is the absence of micro-foundations. To make them realistic, stock-flow models begin with a description of all the linkages between the real and financial sectors of an economy. However, the problem with this aggregative point of departure is that the differences between the sectors are foregrounded at the expense of what they have in common, an imbalance that then results in a loss of coherence in that they appear to operate to different logics. Post-Keynesian stock-flow models must be externally realistic, but if they are also to be internally consistent they must begin with a micro-foundational unit of analysis on which can be built an overarching framework that satisfies both criteria. Lysandrou concludes that the unit of analysis that best fits this purpose is Marx's concept of 'commodity'.

We, as members of the organizing committee of the 10th International Conference entitled *Developments in Economic Theory and Policy*, would very much like to thank the relevant referees of the papers included and the contributors for their papers in this special issue, all of whom closely collaborated in preparing the final versions for publication. We also wish to thank the organizers of the Bilbao conference for all the help and funding of the special session out of which the contents of this special issue are now published.