

# Breaking Boundaries in Economics: Turning Methodological Blind Spots into Exciting Research Opportunities

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# Economic Methodology: Many Major Mistakes

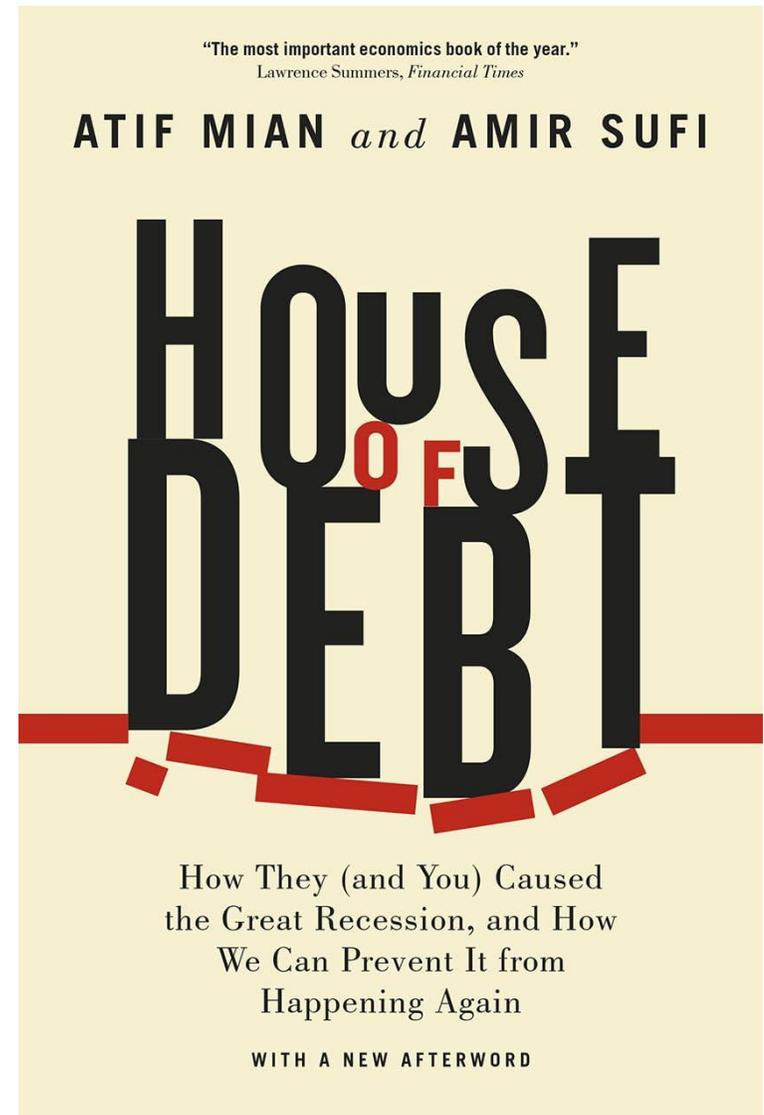
Global Financial Crisis 2007: Economists confidently rejected warnings. It was – and remains – impossible according to all standard Macro Models.

See: [bit.ly/WEAquo](http://bit.ly/WEAquo)

Krugman: the economics profession went astray because economists, as a group, mistook beauty, clad in impressive-looking mathematics, for truth.

The Great Depression => creation of Macroeconomics by Keynes.

Keynesian Macro cannot be understood without GD background



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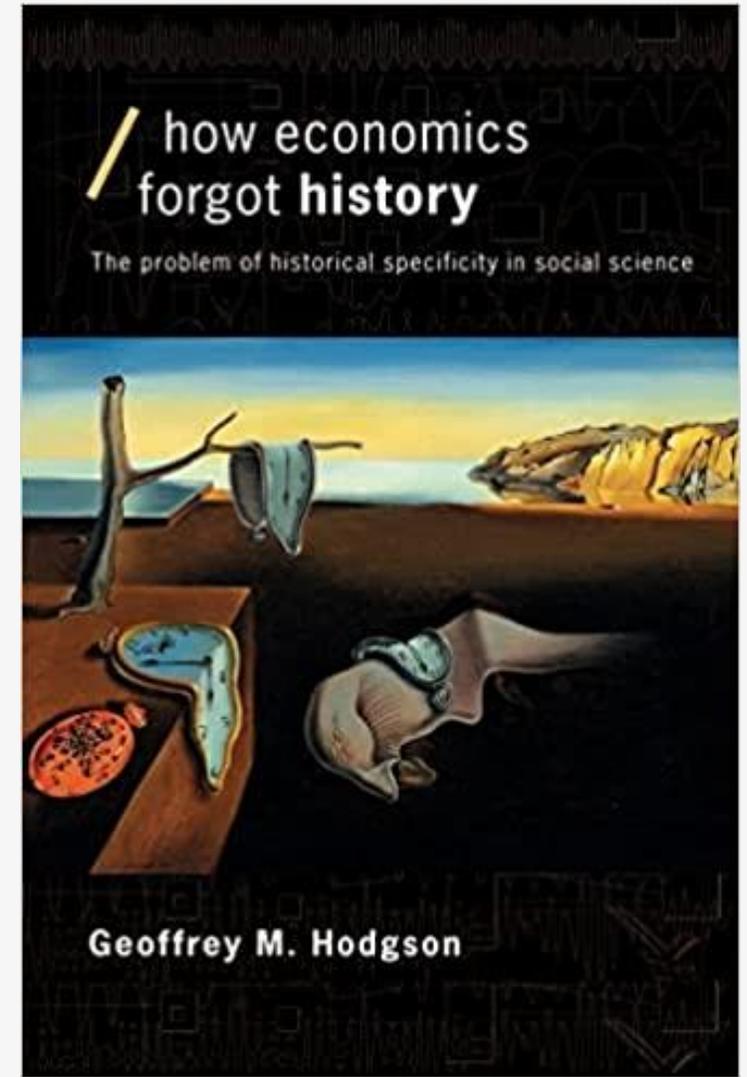
# How Economics Forgot History

The Battle of Methodologies in late 19<sup>th</sup> Century:  
positivism vs anti-positivism: appearances vs  
reality

Does History Matter? The problem of historical  
specificity.

Mistaken Methodology: Historical context does not  
matter.

Research Opportunity: Economic Theories can only  
be understood within historical context



# Example 1: Keynesian Macroeconomics

Great Depression of 1929: Very Similar to GFC 2007. All major economists (including Keynes) confidently predicted prosperity.

Great Crash was clear evidence of serious foundational errors.

Keynesian Economics: Money Matters!

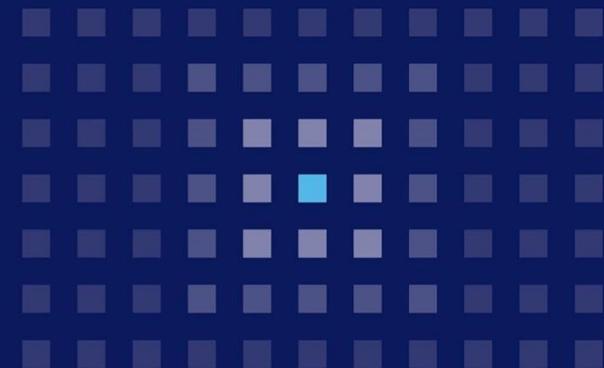
The economy is complex: the whole is not a sum of the parts. Micro behaviors cannot be aggregated to get macro picture. (ABM)

ZOOM  
ECONOMY

Syed F. Mahmud / Kaoru Yamaguchi / Murat A. Yülek

## Money Matters

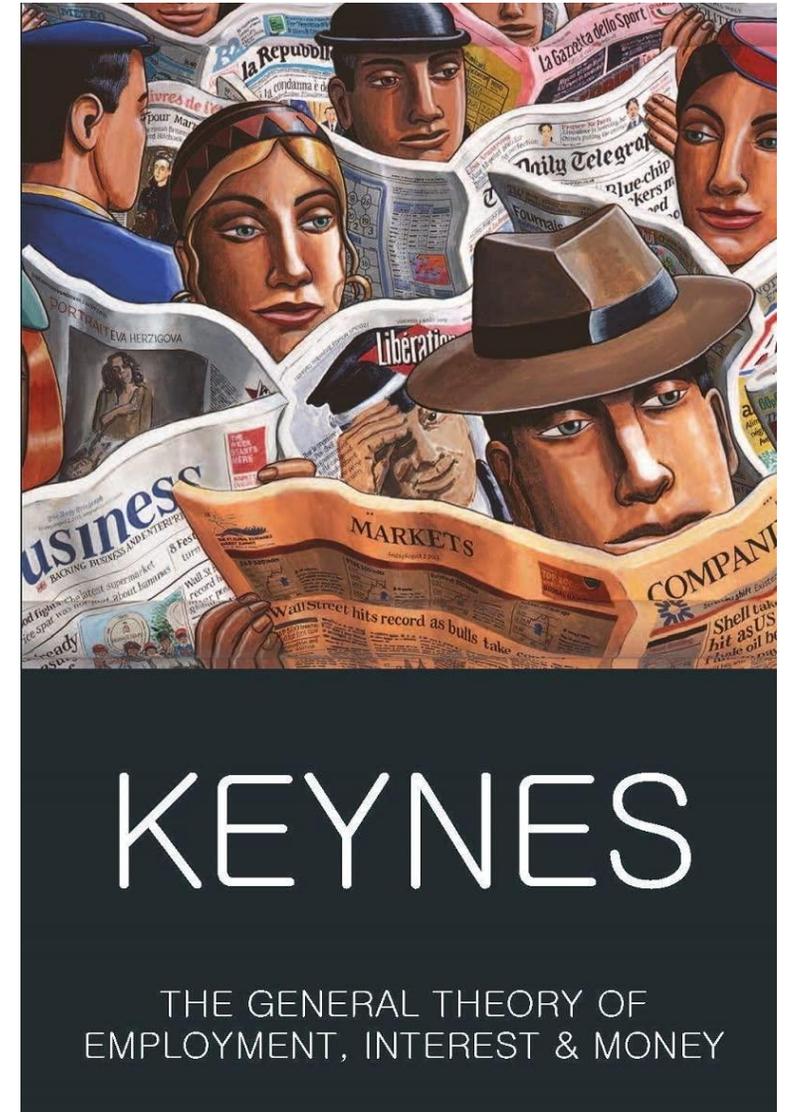
Some Puzzles, Anomalies and  
Crises in the Standard Macroeconomic Model



PL ACADEMIC  
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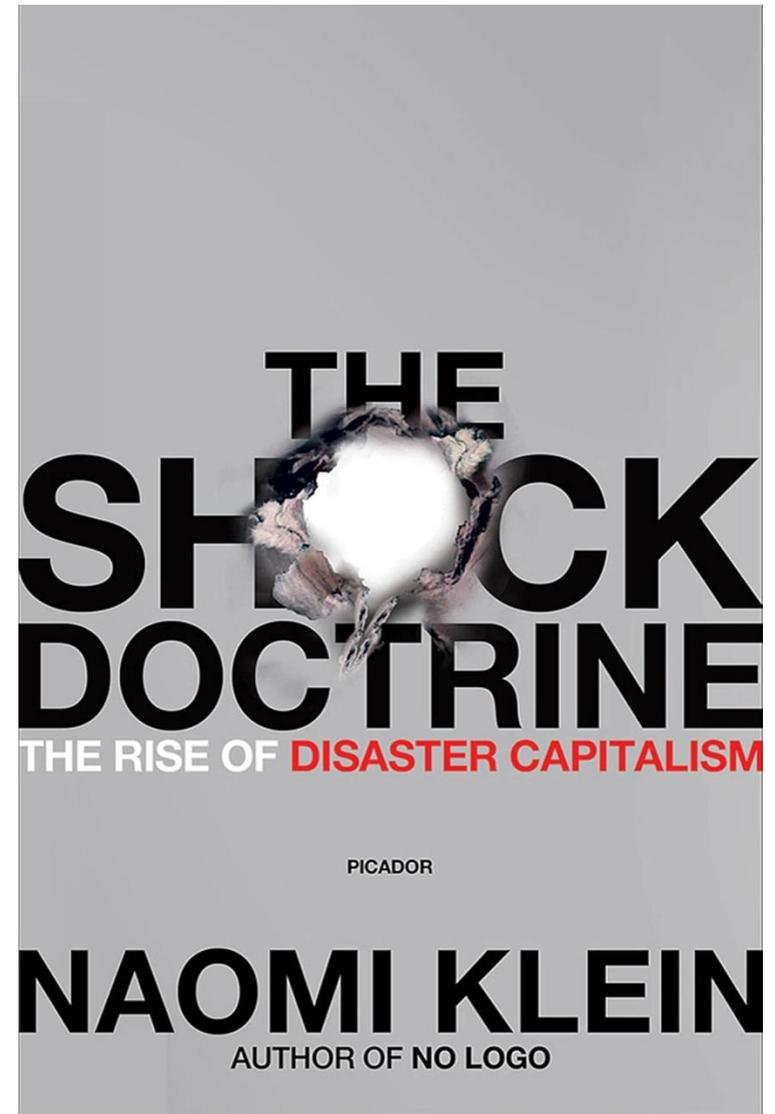
# Keynes created Macro to Understand GD 29

- Central Problem was persistence of unemployment – impossible according to S&D in labor market.
- Keynesian analysis: Labor market S&D based on nominal wages.
- Price level is determined at macro level, beyond reach of agents.
- If all firms lower wages, this will lead to lower prices, and possibly increase real wage. Thus, real wages cannot be lowered to reduce unemployment.
- Macroeconomics phenomena differ from Micro. The famous Savings Paradox.



# Samuleson Hicks Distortion of Keynes

- The IS-LM interpretation of Keynes eliminated complexity. Reduced Keynesian economics to wage-rigidity, in downward direction.
- Policy Implication of Keynesian Economics: Market forces do not create full employment. Governments must do so via monetary or fiscal policy.
- 1950-1975 was golden age of capitalism. Western economies had full employment. Massive transfer of wealth from Wealthy to Poor.
- Chicago Counter-Revolution: Naomi Klein: Disaster Capitalism



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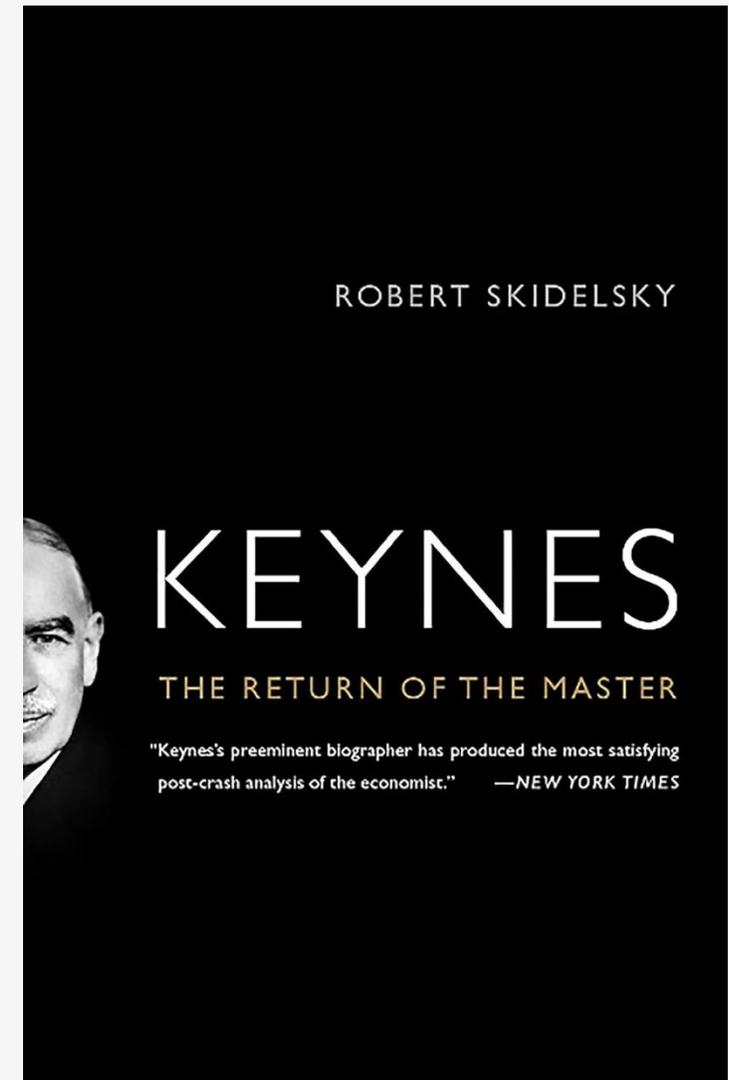
# Critical Insights of Keynes were rejected!

- The Economy is Complex: Macro differs from Micro
- Radical Uncertainty: No one can predict future.
- Money Matters in short and long run – it is not neutral
- Supply and Demand equilibrium does not determine prices.
- Full Employment is not automatic, but policy determined.

NONE of these lessons come out of modern macro models.

We now have ABM techniques available to create realistic models!

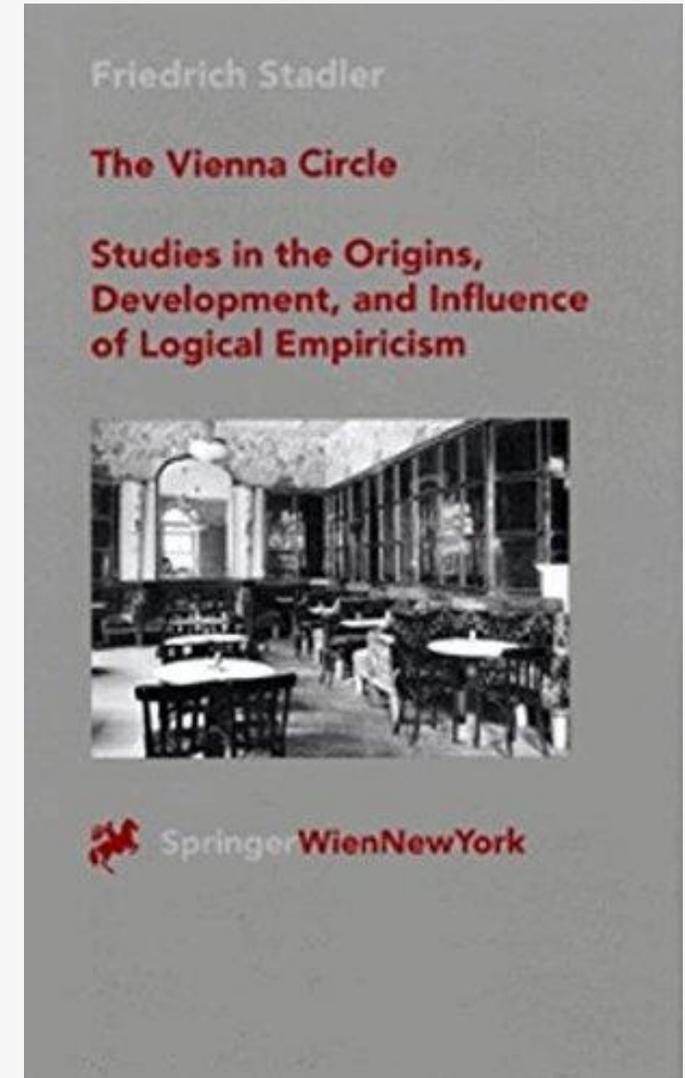
See: Understanding Macro (1,2, & 3); <http://bit.ly/WEAgd29>



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# Economics as a “Science”?

- Centuries of Religious Wars => Secular Societies & Social Theory
- The hope was that rational and empirical methods would lead to consensus on truth, and peaceful societies.
- World War 1 shattered this hope, and destroyed the prestige of qualitative and historical social theory.
- Positivism emerged as a theory of science, and provided foundations for an entirely new approach to economics.



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# Material Welfare => Scarcity

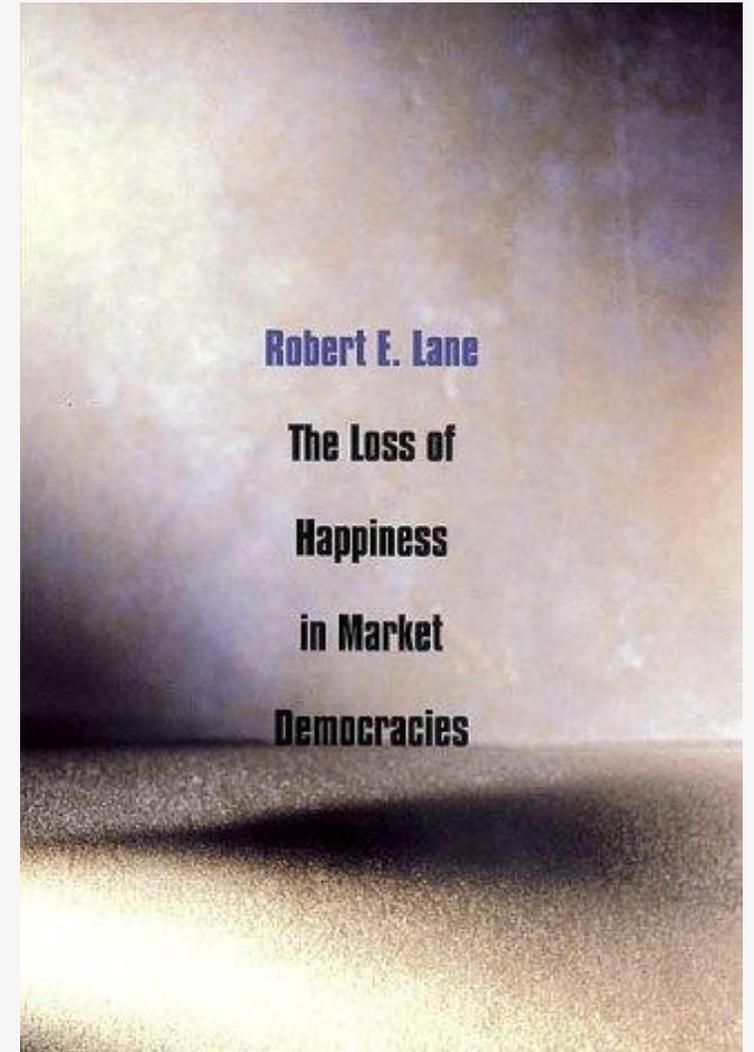
Normative Foundations of Scarcity:  
<https://ssrn.com/abstract=1554202>

Human welfare is subjective, psychological, not scientific!

Scarcity led to focus on GDP, neglect of distribution.

Neglect of sources of human welfare led to the Easterlin Paradox.

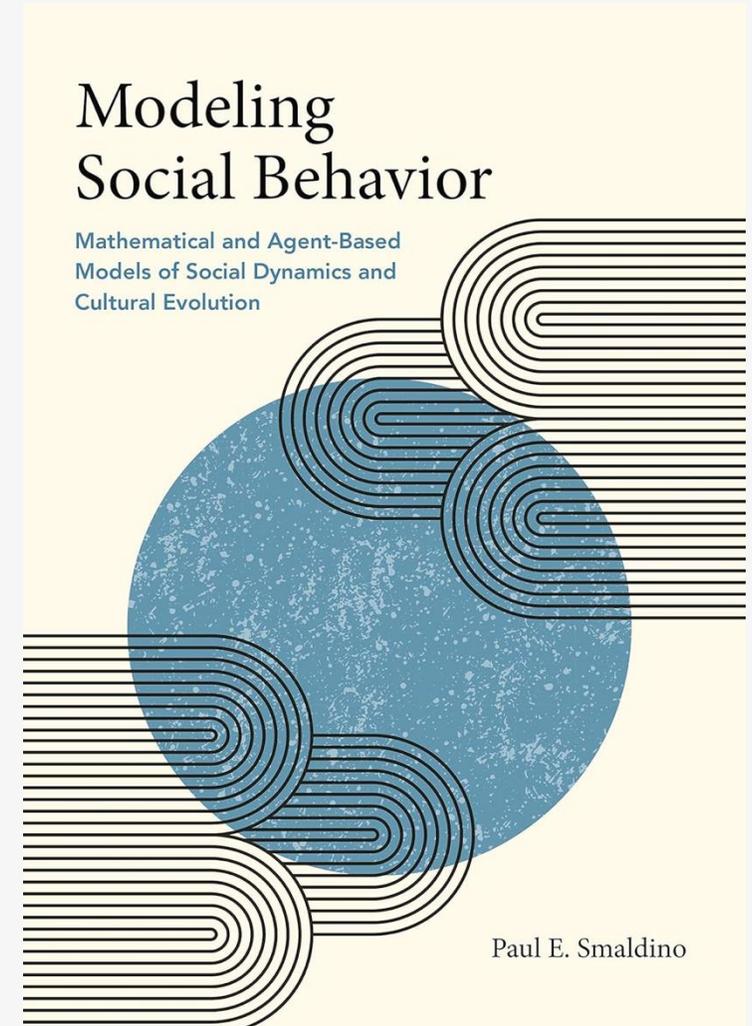
Economic growth does not lead to increase in happiness.



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## Second Research Opportunity: Focus on Sources of Human Welfare

- Short run welfare depends on consumption.
- Long run welfare depends on character and social relationship.
- Social networks are easy to model via ABM, and impossible via conventional methods. Low Hanging Fruits & Easy Pickings.
- Massive policy implications: major welfare increases are possible without significant changes in GDP.
- Character, Social Relationships, Social Norms, easy to model within ABM.



# How Methodological Mistakes Cripple Economic Research

# Keynesian Issues

- Failure to understand causes of inflation and unemployment.

Tarullo: Monetary Policy without a working theory of inflation – see: <http://bit.ly/weaCCT>

Inflation occurs due to class conflict. Workers want higher wages, Capitalists increase wages, and follow up by increasing prices.

Prices are determined by markup over costs, not by S&D.

Energy prices and import prices closely linked to inflation. Self-sufficiency in food and energy critical to a sound economy.

# Welfare Costs of Unemployment

- **Mental Health Issues:**

- Unemployment is linked to increased rates of depression and anxiety. Studies indicate that unemployed individuals are up to **three times more likely** to experience mental health problems compared to those with jobs.

- **Family Breakups:**

- Unemployment can strain family relationships, leading to higher divorce rates. Research shows that economic stress contributes to marital instability, with studies suggesting that unemployment can increase the likelihood of separation by **up to 50%**.

- **Suicide Rates:**

- There is a well-documented correlation between unemployment and increased suicide rates. A study found that for every **1% increase in unemployment**, the suicide rate can rise by approximately **0.79%**.

- **Substance Abuse:**

- Unemployment is associated with higher rates of alcoholism and substance abuse. Research indicates that unemployed individuals are more likely to engage in harmful drinking behaviors, with some studies showing an increase in alcohol consumption by **20-30%** among those without work.

# The Great Depression - Multiple Theories

1

Keynes

Collapse of aggregate demand.

2

Friedman

Bad monetary policy by the Federal Reserve.

3

Fisher

Debt-Deflation spirals.

4

Kindleberger

US insistence on repayment of war debts from European allies.



# Wars and Money

- Bank of England created to support English war against France.
- Gold standard supported/created UK hegemony until WW1.
- Inter-War Period: USA effort to replace UK as world hegemon.
- WW2: Bretton-Woods replaces Sterling Standard by US Dollar
- This enables free financing of US Wars around the globe: See Michael Hudson: Super Imperialism.
- Vietnam War => Nixon Shock: Abandonment of Gold Backing
- Fiat, Floating Currencies require a COMPLETE rethink of monetary policy – which has NOT been done.

# Economics & Wars: Welfare Costs Ignored

ROKE: The political economy of war, peace, and the military-industrial complex.

1 (Jeffrey Sachs) US global hegemony versus multi-polarity.

2&3 (Robert Skidelsky) (Wolfgang Streeck) political economic drivers of war

4 (Thomas Palley) examines the political economy of the Military-Industrial Complex and its structural proclivity to foster militarism and war.

5 (Cecilia Rikap) Big Tech and the US National Security State.

6 (Brancaccio, Giammetti, and Lucarelli) explores the role of global payments imbalances in provoking conflict.

7 (Keyu Jin) explores the geoeconomics of US – China relations.

8 (Dani Rodrik) imagined global economic order that might replace Neoliberal globalization.

# Research Advice for Students: Disruptive Innovations

# Strategy: Don't be revolutionary

Krugman: By the early 1980s it was already common knowledge among people I hung out with that the only way to get non-crazy macro-economics published was to wrap sensible assumptions about output and employment in something else, something that involved rational expectations and intertemporal stuff and made the paper respectable. And yes, that was conscious knowledge, which shaped the kinds of papers we wrote.

# Meyer: RBC Models

RBC models are a “caricature that’s so silly that you wouldn’t want to get close to it if you were a policymaker. ... My views would be considered outrageous in the academic community, but I feel very strongly about them. Those models are a diversion. They haven’t been helpful at all at understanding *anything* that would be relevant to a monetary policymaker or fiscal policymaker.”

(Opportunity: Focus on Pragmatics, Run/Simulate Policy comparisons) Models which failed in GFC are STILL in use around the world.

# Use Historical Context to Drive Research

- Locally, Historical Context forms a static background – which makes modern methodology applicable.
- Rich and Diverse Environment can be modeled within ABM.
- As researcher, extremely important and useful to be aware of the historical background.
- My own participation in the Monetary Policy Committee – The historical development of central banking was crucial to understanding current policy concerns.

# Climate Change

- Equilibrium and Optimization models cannot study process of systematic social and environmental change.
- Dynamical Systems approach can handle change and create far superior models – Steve Keen, Syed Fakhre Mahmood.
- ABM models are superior, because they can handle social change, PROVIDED that creator of model has historical knowledge and imagination.
- Major opportunities exist in this area, but some parts are also heavily researched. The intersection of environment and economics is under-researched, with wrong methodologies.

# Inflation, Unemployment, Welfare

- Current models do not explain inflation or unemployment, and do not correctly capture welfare costs.
- This is not possible to do, outside of ABM models, which provide a natural way to model class conflicts.

# General Principle: Make Human Welfare the Goal, instead of GDP

- Social Networks are critical to surviving crises.
- Intergenerational Justice cannot be addressed by Utility Max
- See: Karacuka and Zaman: Empirical Evidence Against Utility Maximization: A Survey of the Literature.
- Replace Short term utility maximization by long run welfare maximization.
- Again, ABM provides the enabling tool.

# Analyze specific events: Economists Versus Islamists

This battle is also taking place in Pakistan. Islamists want to lower interest rates, while Economists want them higher.

Specifics: If we lower interest rates, TL becomes less attractive. People will switch savings to Dollars, causing exchange rate to crash. This will cause imported-inflation.

**SOLUTION:** Develop self-sufficient economy in food and energy. Once imports are not-essential, crash of exchange rate is USEFUL. It is very efficient industrial policy, leading to import-substitution, and development of productive economy.

# Income and Wealth Inequality

Critical Topic: Scarcity (Growth) versus Welfare (Distribution)

Lucas: The worst topic to research is Income Distribution

ABM is naturally adapted to study distribution, because of heterogeneous agents.

Effects of policies on income distribution.

Effects of inequality on welfare.

# Agent Based Models: Essential Tool for Future

# Two Areas for Disruptive Innovations

There was a lot of excitement about ABM and Evolutionary Economics.

But the results in these areas conflicted with mainstream ideology.

As a result, these areas have been suppressed, and no longer topics of mainstream research.

Both areas have ENORMOUS potential for exciting research.

Both are MUCH easier to learn than advanced mathematical techniques requires for mainstream models and econometrics.

# Agent Based Models:

## A Way of Thinking about Economic Problems

- Use ABM to study the simplest economic problems. You will find surprising results.
- One example: S&D in housing rentals – as per Mankiw.

# 10 Students and 10 Homeowners

- Students have rental budgets of 100, 200, ... , 1000 per month.
- HO's have minimum rents of 100, 200, ... , 1000 per month.

What will happen?

S&D Equilibrium: Rent = 550: Five wealthy students get rentals, Five poor students go back home, without education. Five richest homeowners get renters, Five poorest have empty houses with no renters. This is OPTIMAL outcome, maximizes surplus.

# Micro-structure Matters

- Many different kinds of arrangements are possible – information costs, transaction costs, renegotiation costs.
- Randomly match students to houses, and clear transaction if housing is affordable. Have a second round for those who did not clear.
- This leads to low efficiency. Efficiency can be improved by announced prices. Matches empirical finding that raising minimum wage leads to more jobs.
- Welfare considerations are far more significant. Matching houses to students leads to massively improved welfare for all.

# Monetary Paradoxes of Baby-Sitting Cooperatives

<https://ssrn.com/abstract=2785952>

How do people form expectations about the future value of money?

Critical to Monetary Policy.

A wide variety of monetary phenomena can be generated within an economy where the real sector remains identical, but the expectation mechanism varies.

# How Did Erdem Stop Inflation in Turkey

- By changing inflationary expectations.
- But how do we change inflationary expectations?
- It requires a credible stance, some quick wins, and correct understanding of the physical mechanisms as well as the correct understanding of how expectations are formed.
- How George Soros gambled and won against the Bank of England.
- This understanding leads to a radical reconceptualization of monetary policy

# Concluding Remarks

- ABM models are easy to learn, far easier than mathematics.
- ABM models allow rich models, full of historical details, institutional structures, and many other realistic elements.
- We build the extremely complex model, and simulate it to understand the economy.
- Computational revolution occurred in Engineering in the 1980s. Similar revolution is now possible in Economics.
- You can change the world.