Paradigms Shifts and Major Economic Institutions

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Agenda

1. Introduction
2. Political-economic paradigms
3. Examples of shifting ideas by policy area and institution
4. Analysis

Introduction

Aims:

- Characterise different ‘political-economic paradigms’ across economic policy areas
- Understand the state of debate within major economic policy institutions
- Draw conclusions as to the overall state of a paradigm shift

Method: literature review, surveys, interviews

Part of our wider work on understanding the changing nature of economic thought and policy and the idea of a ‘paradigm shift’

Political-economic paradigms

A system of economic thought and policy which dominates policy-making and provides the dominant frame for public debate about it

1. A set of economic goals / problems regarded as most important
2. A general analytical framework for understanding the way economies and societies work
3. A public narrative and language which simply describes and justifies the goals and analytical framework
4. A set of principal economic policies which will achieve the goals / overcome the problems, based on the analytical framework

Paradigm shifts and modifications

- Dominant political-economic paradigms can become displaced after periods of economic crisis when they appear to have ‘failed’
- They can also be ‘modified’ changed in response to new goals or policy consequences, while core underlying framework is retained
- Examples of paradigm shifts:
  - 1940s Keynesian turn after 1929-30s Crash and Great Depression
  - 1980s ‘free market’ turn after 1970s crises (oil shock / stagflation)
- Example of paradigm ‘modification’:
  - Introduction of more active supply side policies and public services spending in 2000s under social democratic governments

Caveats

- Paradigm shifts and modifications have a general international character but occur in different ways in different countries. UK/US experience is different from German, French, Nordic, Japanese
- We draw mainly on the Anglo-American experience, because this tends to dominate major economic institutions
- We use ‘orthodox’ to mean the dominant paradigm largely adopted since the 1980s
- We mean ‘new’ to mean a possible alternative approach under discussion in some academic and policy circles. Some aren’t ‘new’ ideas but have been around for many years
- This is over-simplified. But we believe it is heuristically useful

Paradigms by policy area

We have attempted to identify where major economic institutions are currently positioned across ‘orthodox’, ‘modified’ and ‘new’ paradigms, in relation to ten key areas of economic policy. Here we present a few illustrative examples

- Based on a literature review, particularly statements from institutional leaders, and survey respondent
- This is inevitably a subjective approximation
- Institutions will have a plurality of views across their staff and various sub-departments; we have tried to capture main positions (e.g. IMF policy view may differ from the research department)

Paradigms by policy area

	Orthodox	Modified	New
Paradigm summary			

Banking and finance (1)

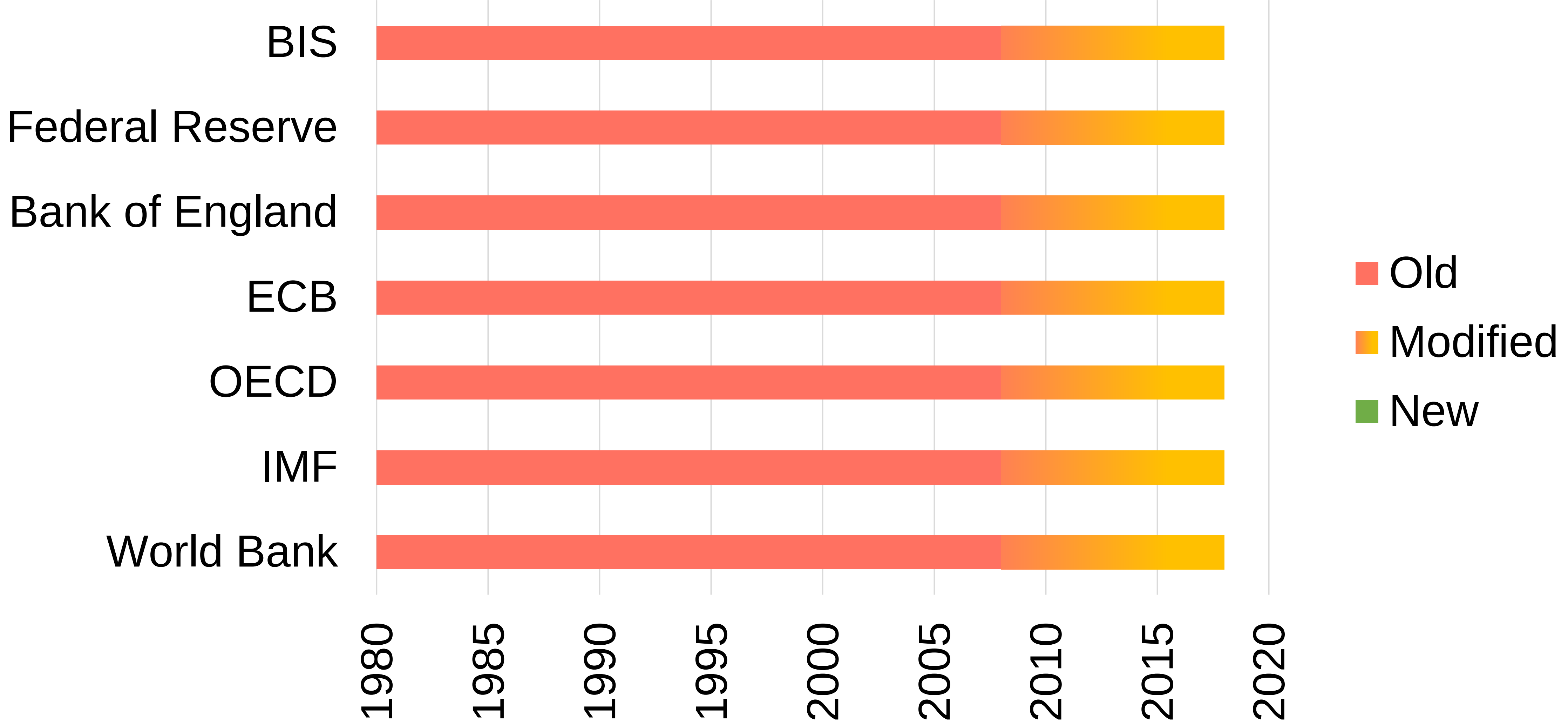
	Orthodox	Modified	New
Paradigm summary	Increasing financial sector activity is beneficial. Money is a 'veil' over the real economy, therefore the financial sector can be excluded from macroeconomic models. Financial and economic crises are caused by external shocks.	Growth in the financial sector is good only up to a point, after which it can become a drag on economic growth. The activities of the financial sector can create systemic risks and cause crises, therefore macroprudential regulation should be introduced.	Much of the financial sector's activity is focused on the extraction of short-term capital gains at the expense of value creation, contributing towards financial instability, inequality and lack of investment.

Banking and finance (2)

“There comes a point where further enlargement of the financial system can reduce real growth… This evidence, together with recent experience during the financial crisis, leads us to conclude that there is a pressing need to reassess the relationship of finance and real growth in modern economic systems. More finance is definitely not always better.”

Bank for International Settlements (2012)
‘Reassessing the impact of finance on growth’

Banking and finance (3)



Inequality (1)

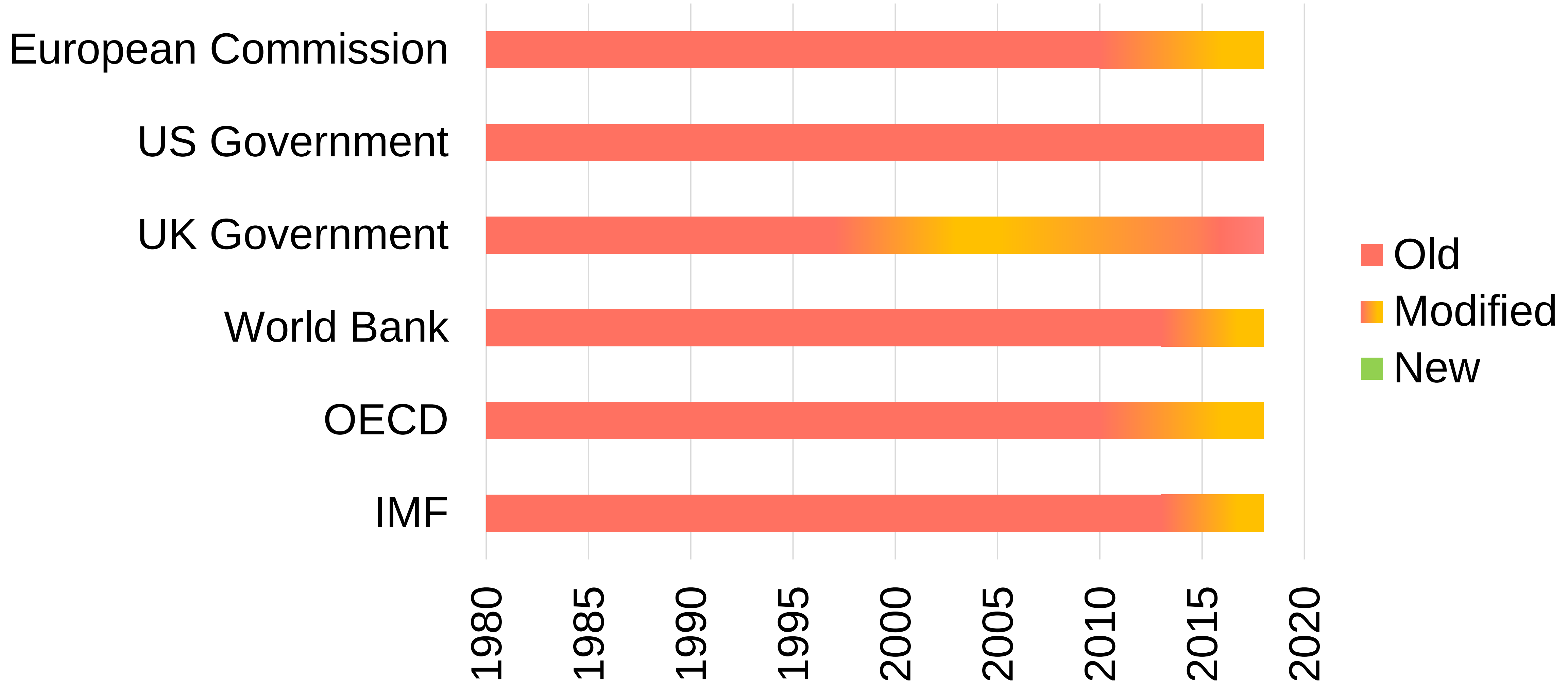
	Orthodox	Modified	New
Paradigm summary	Inequalities arise naturally in a market economy from differences in productivity, skills and effort. Policy should focus on delivering economic growth: ‘a rising tide lifts all boats’.	The benefits of economic growth aren't always shared across society, and too much inequality can be bad for economic growth. Inequality can be reduced by prioritising "inclusive growth".	Inequality is not the natural result of market forces. The distribution of income and wealth is largely determined by the balance of economic and political power between different groups and stakeholders. Exploitation of and changes to the rules that govern the economy has enabled income and wealth to flow upwards away from wage and salary earners towards those who can command rents.

Inequality (2)

“More equal countries tend to have healthier people and be more economically efficient than highly unequal countries. And countries that invest smartly in reducing inequality today are likely to see more prolonged economic growth than those that don’t. Less inequality can benefit the vast majority of the world’s population.”

World Bank (2016)
‘Taking on Inequality’

Inequality (3)



Role of the state (1)

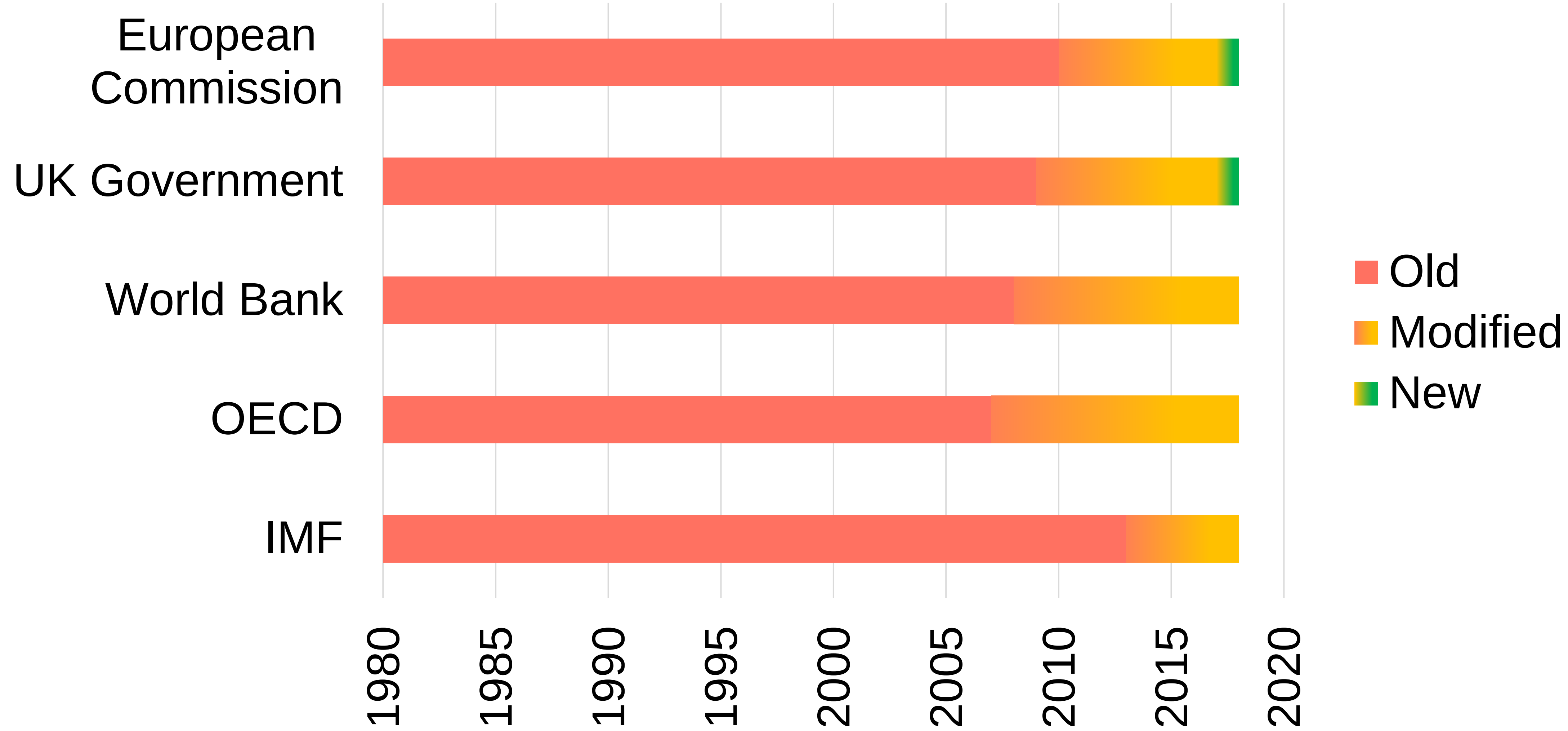
	Orthodox	Modified	New
Paradigm summary	Resources are most efficiently allocated by profit maximising firms operating in a competitive market. The state should only seek to intervene in the economy where markets fail to address market failures.	Supply side industrial policy can be justified where interventions are of a 'horizontal' nature. Picking winners should be avoided.	Limiting the state's role to 'fixing' market failures overlooks the historical role of the state in creating and shaping markets, driving innovation and nurturing new industrial landscapes. This is needed to drive investment and address major socio-economic challenges.

Role of the state (2)

"Acknowledging the direction of technical change requires a quite fundamental re-thinking of the role of government and public policy in the economy. In particular, it requires a new justification of government intervention that goes beyond the usual one of the state as "repair shop"… Policy in this context will now also have to be about co-creating and co-shaping markets."

European Commission (2018)
'Towards a Mission-Oriented Research and Innovation Policy'

Role of the state (3)



Economic goals (1)

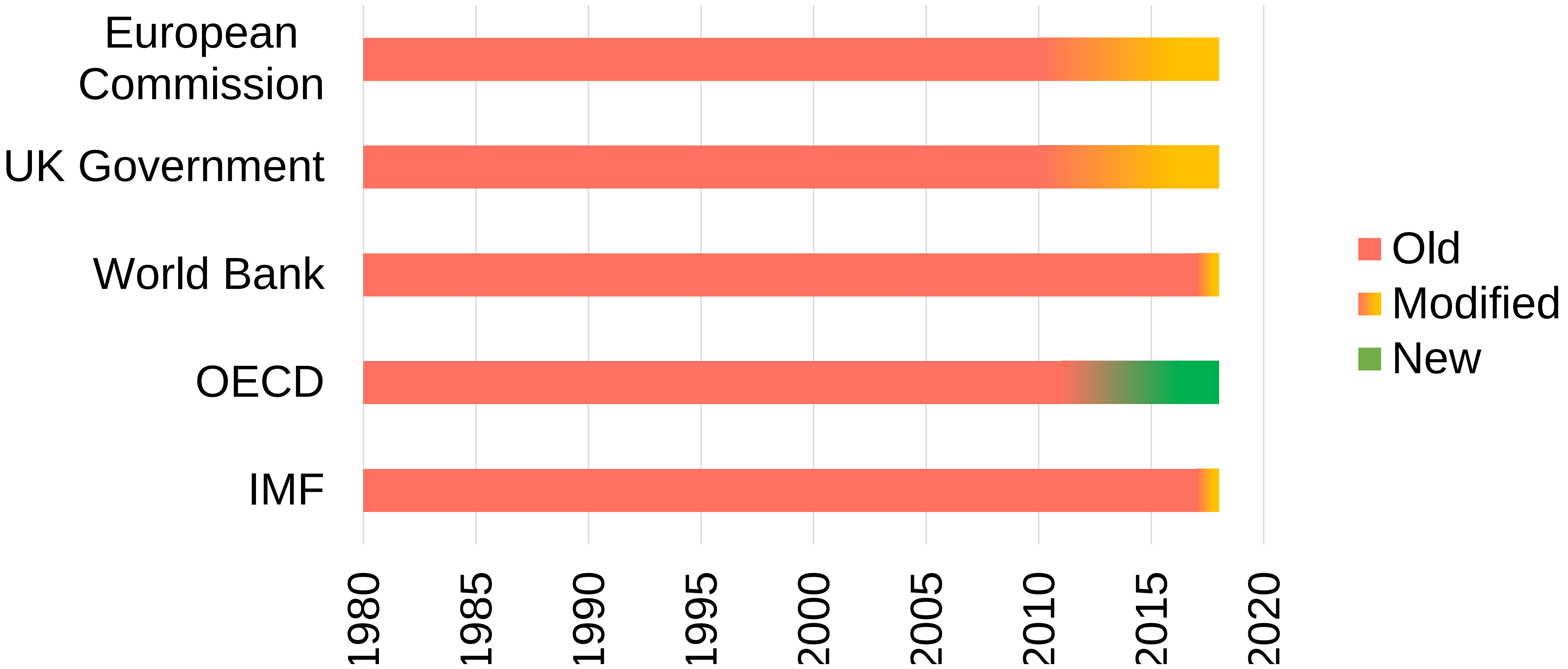
	Orthodox	Modified	New
Paradigm summary	The goal of economic policy is to stimulate GDP growth and thereby raise social and individual welfare.	GDP should be the dominant measure of economic success, but should be supplemented by measures of other economic goals, including employment, poverty, inequality and the environment.	GDP growth is a very poor measure of prosperity. Alternative measures of prosperity are needed which value wellbeing, inequality, the sustainability of the natural environment and wider social goods.

Economic goals (2)

“There is more to life than the cold numbers of GDP… The OECD Better Life Index allows you to compare well-being across countries, based on 11 topics the OECD has identified as essential, in the areas of material living conditions and quality of life.”

OECD (2018)
‘Better Life Index’

Economic goals (3)



Monetary policy (1)

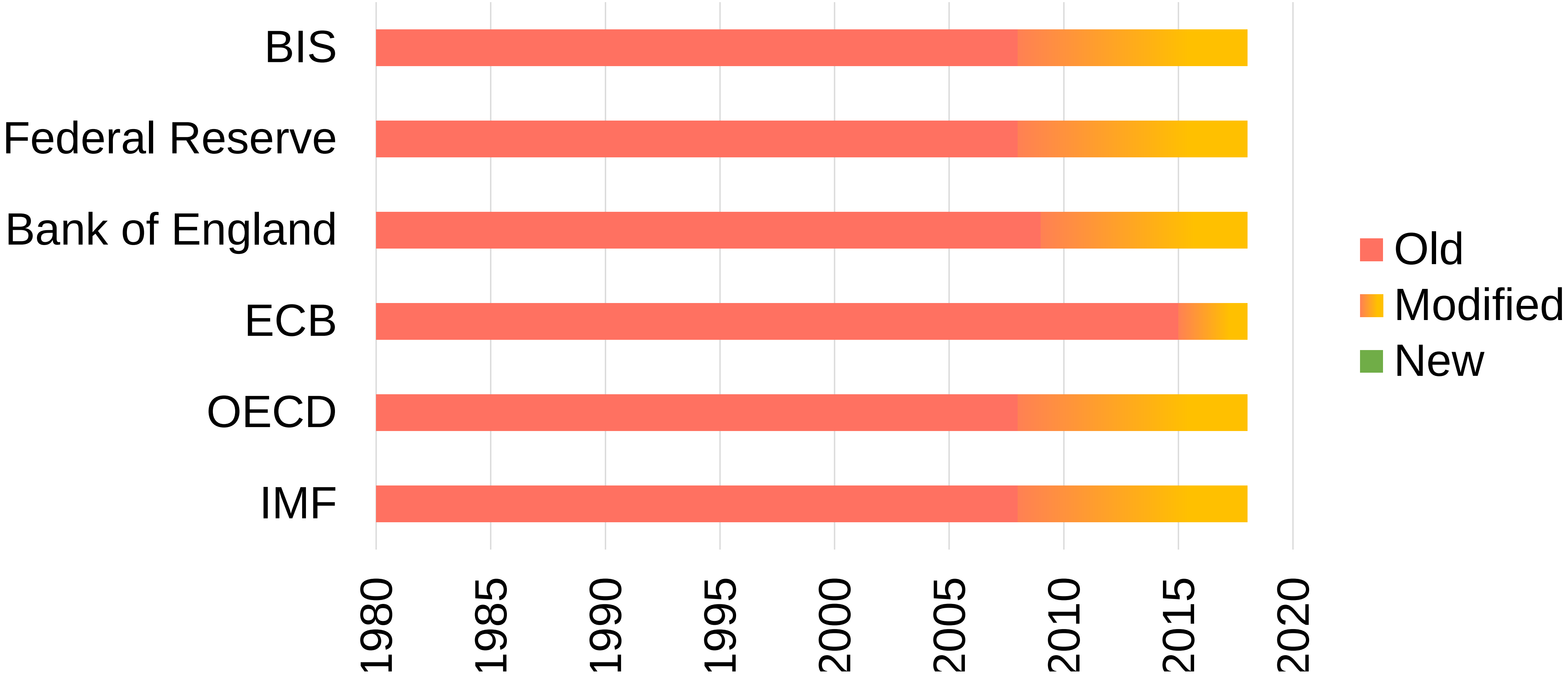
	Orthodox	Modified	New 1	New 2	New 3
Paradigm summary	The goal of monetary policy should be price stability. This is best achieved by an independent central bank controlling base interest rates to meet a target rate of inflation.	In times of crisis when interest rates are near zero, central banks may temporarily use a wider range of unconventional tools to achieve monetary policy objectives.	Credit markets are subject to multiple market failures which create a misallocation of capital and asset bubbles. Policymakers should regulate the total quantity and allocation of new credit through the use of credit guidance tools.	Manipulating base interest rates is an ineffective way to manage the macroeconomy. Ggovernments should manage demand by using fiscal policy and Overt Monetary Financing (OMF).	Commercial bank credit creation is a major source of inequality and financial instability. The power to create new money should be returned exclusively to the central bank via full reserve banking or a 'sovereign money' system.

Monetary policy (2)

“With interest rates already not far from zero, our ability to use conventional monetary policy to provide additional accommodation was now constrained… Under these conditions, the ECB had to resort to a new approach to expand its monetary stance, one based less on adjusting its main refinancing rate, and more on directly influencing the whole constellation of interest rates in the economy that are relevant for private sector financing conditions.”

Peter Praet, Member of the Executive Board of the ECB (2017)
‘The ECB’s monetary policy: past and present’

Monetary Policy (3)



Analysis (1)

- Most institutions have moved to the ‘modified’ paradigm, at least in their intellectual approach, or are in the process of doing so in specific policy areas. There are few examples of no shift occurring.
- Some tentative signs of ‘new’ paradigm approaches in e.g OECD.
- Intellectual change is not often followed by change in policy/action – yet. National governments appear to be lagging behind the intellectual shifts that are taking place in policy institutions.
- There are some examples of regression from modified to orthodox, including the approach to fiscal policy taken by the UK Treasury. These examples are rare.

Analysis (2)

- There are competing ideas of ‘new’ approaches, some of which are very old – eg those from the previous, social democratic/Keynesian orthodoxy
- Orthodox / modified / new differs across the varieties of capitalism – clear distinction between Anglo-Saxon and continental Europe (as expected)
- Overall, the results confirm the general thesis of a clear distinction between orthodox, modified and new paradigms

Analysis (3)

- None of these developments yet adds up to a complete political-economic paradigm shift, on a par with the 1940s and 1980s shifts.
- However, growing recognition of the continuing problems of western economies – slow growth, stalling productivity, financial risk, excessive and/or rising inequalities, environmental unsustainability – is causing questions not just about the inadequacies of the orthodox paradigm but of the modified version too.
- The intellectual and political constituents of a paradigm shift are beginning to emerge, with greater solidity in some areas than others

Thank You

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For more on paradigm shifts see Laybourn-Langton, L. and Jacobs, M. (2018), ‘Paradigm shifts in economic theory and policy’. *Intereconomics: Review of European Economic Policy* 53 (3): 113-18