The Lure of State Capitalism: A CRCE Colloquium

The limitations of economics as a guide to the choice of economic institutions and the prediction of fundamental change
Discussion introduced by Stefan Hedlund drawing on his *Invisible Hands, Russian Experience and Social Science* (Cambridge UP, 2011)

Chairman: John Moore
Discussion leaders: Stefan Hedlund, Philip Hanson

John Moore: We begin with Stefan Hedlund's paper, which I found fascinating. I wrote down a bunch of comments on it, but I am not going to make those comments right now.

I thought that I would just mention two questions that occurred to me. I am not saying that these need to be discussed on this occasion, but they captured my attention. The paper, it seems to me, emphasises the importance of culture and customs in efforts to transfer institutions from one society to another. And in this respect it very much reminded me of the work of another participant here – Steve Pejovich – who has done a lot of work on this very same subject. A slightly different vein, I think, but many of the same themes. The two questions that struck me upon reading Stefan's paper – that I would like to just mention here – are these. On page 244 he argues that "in some cases such informal cases some traditions will promote behaviour that is in line with liberal free market tradition; in others they will promote actors, including government, to promote action that is clearly against the common good." So two questions here – what are the cases in which they promote behaviour in line with the liberal free market tradition, and in what circumstances do they not? But then another question occurred to me; and I think we are seeing this to a certain degree in the United States right now. Over time, norms and values may also produce a majoritarian democracy, as opposed to a republic. And a majoritarian democracy *can be* – and often is – inconsistent with the liberal free market tradition. So it seems to me that there is a tension there: that the very same norms and values that may promote a liberal tradition can also promote a majoritarian democracy that is anti-liberal. That struck me as an interesting point.

And then on page 267 – and some of this is Hedlund and some of this is Jon Elster – there is a discussion of the scope for deliberate intervention to result in specifically aimed-for outcomes. And Elster says that we should concentrate on specifying small and medium sized mechanisms for human action and interaction. This reminded me of the piecemeal social engineering versus planning versus debate that was engaged in some years back. It also reminded me of some work that some people here know, and the rest of you should! That work is by Warren Nutter, who was a Professor of Economics for many years at the University of Virginia, and who did a lot of work – some very pioneering work – on the Soviet economy; 60 years ago now.[1] The paper that I am referring to here is not on the Soviet economy, but it is entitled *Economic welfare and welfare economics*; published in 1968. One of the main points in this paper is the following: we cannot predict the consequences, or *all* the consequences, of actions we take – there will always be unintended consequences that we cannot foresee. However, he also says that any action we take has irreversible consequences; irreversible, unforeseen consequences. Given that – there are some consequences that we do not predict, and that we cannot reverse or change later on – the better policy is to take small actions. Even if we know that there is a theoretical ideal, like Pareto optimality that cannot or will not be attained in the course of taking these small actions. So this point seems to me to be consistent with what Elster is saying, at least with regard to small – I do not know about medium-sized – mechanisms.

These are just two points that I would like to raise, although there are many more that I could have mentioned. Again, not necessarily for discussion, but if they are of interest to anyone I can bring them up. Now as for the discussion itself – the rules of the game. I mentioned to Stefan that I am an old Liberty Fund guy; and I know that many of you are very familiar with Liberty Fund procedures, which I think work pretty well in general. So I am going to try to follow something like that here. Now what does that mean? It means, first of all, that only one person talks at a time, and that we hopefully do not have side discussions going on. Second thing, to maintain some semblance of order, I will keep a list of all those who want to speak. If you want to introduce a new topic, just do this with your namecard and I will write your name down. So we will try to follow that procedure; and now I will turn the floor to Stefan, to introduce us to the discussion.

Stefan Hedlund: Thank you very much. It is obviously very tempting to turn to my notes; and to begin my responding to the questions made, but I do not think that I will do that. I would just like to comment on this issue of piecemeal social engineering. Not being a China scholar at all, my impression of a good explanation for the Chinese success is not having “grand designs” on where we want to go – based on textbook advice – but rather we try it out, and we see what work; and we turn what works into a strategy. And what works will often be built on indigenous institutions that are not based on common universal values. I think that is something really important in understanding the Chinese way. They have institutional specificities that they look at, and play with, and some things work and others do not. In this way they kind of meander their way through, pretty successfully to-date.

I will return to the more theoretical dimensions of that. That said, I would like to return to what I *thought* I would say. Namely that the topic is economics as a guide, and every time I

[1] For more information on Warren Nutter see: *Looking Forward to the Past*, CRCE, London 2003 p.19-35

think about that I recall this classic "economics as a dismal science" business. And if we look at all the readings we have been given for this conference there is not a whole lot of optimism in them: neither for Russia nor for the United States – perhaps cautiously so for China. I think that my presentation is probably the most dismal when it comes – not to countries as such – but to the role of economics, of social science in general, in being capable of guiding us or doing something about these problems that are quite substantial. I would argue that what has been troubling me is how the liberal tradition has come to assume this kind of normative position of this being sort-of close to a mathematic axiom that we are beholden to, and that everything that does not really fit into this pattern is a kind of aberration. If you recall twenty years ago, when we really saw this "divine wisdom" that if you deregulated you were going to achieve nirvana; the rouble would be convertible in six months, and all of that fluff. What I have been thinking about for many years, that prodded me into writing this book, is the notion of systemic failure. In various senses: both the long-term failure to develop and the short-term sudden implosions of systems. Obviously what started me thinking about this was the failure of transition – failure in the sense of what people thought would happen in 1991, and what actually happened. This is of course open to discussion in terms of specificities; but it certainly did not pan out the way we thought. Being trained as a development economist, that always brings to mind what we have learned after four or five decades of trying to alleviate poverty in the third world. It is a disturbing fact that those countries which have succeeded in lifting themselves out of poverty have not been given assistance or advice. So we have a problem here – both in transition and development – in terms of outside-agency-based approaches that generally ignore specificity. This is very high in my mind: the role of cultural specificity and institutional specificities in sometimes producing idiosyncrasies.

The other type of systemic failure obviously is the one we are in the middle of: the global financial crisis and the Eurozone crisis neither of which we know exactly how they are going to pan out. This rather goes back to what John said: sometimes opportunity and self-interest will lead to value added, sometimes it will not. These cases are clearly illustrations of the latter. We focus a lot on how the Russians have been playing fast and loose with taxpayer money, and stealing left right and centre. But in a sense of fairness, who has done most damage to the global economy: Gazprom or Goldman Sachs? I mean we talk about the relations between the Kremlin and Gazprom, but if you look at the relationship between the White House and Goldman Sachs, which is the greater problem to the global economy? Is it in Moscow or Washington? These are illustrations. If you look at the costs that have been inflicted on the global economy by this, it is striking not only in terms of the cost, but also in terms of the failure to react, and actually to recognise that there is a crisis. Remember all the months it took before Washington was even ready to admit that maybe we should do something; and same with the Euro crisis. If we had been able to *see* the crisis, then maybe something could have been done before the fire had reached every room in the building.

My main thesis here is that economics has developed into what I like to tell my students is sort-of "fair-weather science." If everything works fine, then economics is in shape. If we are maximising on the margins, *ceteris paribus*, and all that, then we have good predictive power.

But if we end up in catastrophe and crisis, then the system sort of runs home to mamma: norms and values and beliefs kick in that we do not really understand very well. If we are faced with extra-marginal change on multiple margins, under conditions of genuine uncertainty, people do not know what is going to happen – *then* economics ceases to be very useful. I mean it is not completely useless, but it ceases to be useful in the sense that we like to believe a science is.

What it really goes back to is the inability of economics, and of social science in general, actually to model human behaviour. I think that Friedrich Hayek once said that if we want to model human behaviour then it is a matter for psychology, and not for economics, so we ignore it. And economics has been ignoring the need to model human behaviour, basically going back to the need to understand cognition. I mean everything that we think about bounded rationality and things like that. It really goes back to how good we are at understanding processes of human cognition – how people perceive opportunities. And if we cannot do very well on that count, then the weakest link in the chain will determine the strength of the chain, right?

So this said, we are all familiar with the accusations against economics, in particular for physics-envy. We want to be a real science; we want to have nice models, and laws of economics, have a sort-of upgrade. To migrate from the rest of the social sciences, and become a real, hard science, with nice laws of predictability and all that. Here I love to quote Jon Elster, since I am a huge fan of his works; he covers rational choice and norms and so on. He just says that we have to understand that we are light years away from all of this – there is no such thing as laws of economics in the physics sense. Because these laws will always hinge on what we understand about human behaviour and human cognition; and if we are bad at that then there will not be any laws. This is not intended as a form of economics-bashing, but it is sad in the sense that if you look at neighbouring tribes within the family of social sciences there is this love of economics-bashing, and of deploring 'economic imperialism' and the rest of it. Occasionally economists and sociologists jiggle it out, but if you recognise that, you see also that so many of these neighbouring tribes try to do exactly as the economists do. There is an inconsistency here, with rational choice in particular. The other social sciences really want to become like economics and economics wants to become like physics. *And*, there is path dependency involved here – in the sense that when you want to pick your PhD programme; you apply for research grants and you want to get into the good journals. I mean we know exactly what it takes. It takes not thinking outside the box, it takes being in the middle of the box, if you want to have your success secured. If you are a Professor and you have tenure with a chair and twenty years of seniority, *then* you can speak outside of the box, but not otherwise, because that is condemning yourself to never getting research grants again. So the whole situation is path dependent, and it is deplorable in the sense that I think there is an evil trade-off here. Whereby we bought increasing theoretical and ethnological sophistication at the price of a loss of perspective, and a loss of realisation of what goes on in the other social sciences.

This does not mean that I argue for a return to the German historicism or the American institutionalism, or the times where there was one unified social science. But I do think that we really need to sensitise ourselves to what really goes on across the borders and in other areas. Because my vision of the social sciences is that it is like an expanding universe, where every piece moves away from all the other pieces, and you get huge holes where all the really important and relevant questions are. We cannot grasp at these because we sit on our little island, and hold onto our nice models. We understand fine and well if everything is *ceteris paribus*, but it is outside the box where the real questions are and that is not my turf, somebody else has to deal with that. I see this as a big problem; I do not really see a policy recommendation here, but it is requires cultural specificity and an ability to strike a bridge across economics and sociology on how we understand what drives human action, from the sort-of *homo economicus* to the mindless plaything of some sociologist – of being completely beholden and driven only by norms and things that happened in the past. They both cannot be true at the same time; but then pieces can be true at the same time. We need to think about the balance: what is the relative weight of instrumental rationality versus being mindless playthings and being driven by experiences of the past.

There is no shortage of realisation in the literature of the importance of these moral sentiments. Lionel Robbins: insider self-interest without suitable institutions will be a guarantee of nothing but complete chaos. Doug North once wrote that the neoclassical world would be a jungle ... et cetera, et cetera. And going back to Goldman Sachs and Wall Street once again – I think one thing we could go back and look at in the American intuitionalist tradition is Veblen. I mean everyone loves today to revile Veblen because he said nothing of interest, and they had no theory. But this man was Professor of Economics at Chicago which is a sort of Mecca of Economics today. No other department has so many Nobel prizes in Economics. Not only was he a Professor there, but he also edited the Journal of Political Economy (JPE), which was a flagship journal. And he wrote that in *The Theory of Business Enterprise* – I think it was in 1904 – that there is a big difference between making money and making goods. He really hated entrepreneurs, and was beholden to the "captains of industry" – people who really "made things." And I think that there is still a lot of sense in that, in the understanding that the captains of industry developed one sort of norms and values about their profession and what they do; and they leave behind stuff that they have built and constructed at a value. Whereas financial market "wizards" play with money, have no real understanding what is value-added, and what do they leave behind? I was really taken by an interview with one of the people who was involved in the scandal at Goldman Sachs. He said that the culture at Goldman Sachs is not only that you have to gain but you have to make others lose. So there is a distinct zero-sum nature in this; not a sense that it is a positive sum game, that we are all in this to gain together, and it becomes very much like the Russian *kto kogo*. And that is a very different type of informal norms, structure of values and beliefs of financial markets, that we did have in the old "captains of industry" type of entrepreneurial culture.

There is also in this trajectory no lack of insights. We can go to Ken Arrow, eminent in Economics and possibly the first to get the Nobel Prize, if I remember correctly. He once wrote that we really have to focus on the role of commercial morality. Without commercial morality, commercial transactions will not lead to value-added. Thrainn Eggertsson, who is one of the big names in new institutional economics, once wrote, citing Arrow, that this is the main challenge to new institutional economics, we must understand the role of morality in transactions, in commerce.

Wrapping this up, before I get brutally interrupted! What is so important about what is happening in Russia after the rigged elections in December 2011, is that we can seriously speculate about whether the so-called “Snow Revolution” was brought about by a value shift and a shift in beliefs that had been growing for some time. This seems to have made the Snow Revolution possible, and there is growing evidence that values really were being transformed in Russia before all this happened; and are obviously being driven further by what is happening now. In that sense there may be a cautious reason for optimism about Russia; not in the immediate sense, but longer-term. What Russia really needs is accountability, and constitutional binding of the autocracy and all that. But as I think Barry Weingast once pointed out, this is not achievable by agency alone. You need agency in terms of instituting rules and agencies to constrain the rulers. But if it is to work, then you really need a set of shared mental models, or shared beliefs, amongst the population that make them realise that it is worthwhile, or necessary, to stand up for their rights when those rights are violated. Perhaps what we are viewing in Russia is a sense that the old social contract between the rulers and the ruled has broken down, for reasons that may still be very hazy, and a new situation is emerging where the regime will need to find a new social contract. We all know how fragmented the opposition is, so this is just loose speculation over a possible forecast for the longer term. This type of norm change, and value/belief change, may be on-going in Russia; and in that case I do not know how hopeful we should be. But at least this is something reasonably novel; otherwise we all know that the forecast is not a very happy one.

Philip Hanson: I would like to get a few words in before the dam bursts – if John allows the dam to burst – because I imagine there will be many people with a great deal to say about this.

I have a great deal of sympathy with the general thrust of what Stefan is saying. My take on it is that he is saying that economics, as it is at present, lets us down when we need it most. It is not at all bad at analysing and predicting relatively modest changes within an otherwise broadly stable set of conditions. But when you have major turning points, major turbulence, it does not function at all well. This is clearly true; one could even say trivially true. I mean, we only have to consider the fact that we failed to foresee and take avoiding action, as far as the financial crisis is concerned. We did not foresee the problems that arose in Russia and the other CIS countries in economic transformation.

Stefan's response is to say that amongst other things we are failing to bring in the factor of cognition – informal institutions, norms, this dreaded word *mentalité – mentalityet* in Russian. Dreaded because I have the usual Anglo-Saxon response to that kind of word! But he is saying, with I think a great deal of force, that the sort of broader political economy we see exemplified in Schumpeter and Veblen, and of course originally in Adam Smith, would have tried to tackle these things. Well, so far, so good.

Where I think we may differ – I am not quite sure where Stefan stands on this – is that I do not see the friction between rigour and relevance ending any time soon. I do not see much prospect for a broader political economy delivering the kind of things we are currently missing in any systematic and generally successful way. In other words, I think that we are stuck with this problem for quite a long time – perhaps indefinitely.

I will give some examples of the sort of problem that Stefan is drawing attention to. There is a recent paper by Iikka Korhonen, of the Bank of Finland, and Maria Ritola analysing the performance of private sector forecasters in twenty-one emerging economies over the last fifteen years or so looking at how they have performed, taking predictions as of the April of each year for GDP and inflation, and looking at how that turned out in that year; and the prediction for the following year.

In fact the results are not at all discouraging. They did not find evidence of bias, in the sense that the forecasts were not systematically too high or too low, on average. And across most countries, most of the time, they performed reasonably well. Of course where they did not perform well was in particularly volatile economies, and at major turning points. And that is exactly the problem I think that Stefan starts with.

Let me offer a couple of examples of broader political economy trumping more sophisticated, and if you like more conventional, economics. Now the first point just relies on a memory I have – I do not have a reference for it. But around '91/'92, the Soviet, or ex-Soviet, political economist Leonid Abalkin said that transformation in Russia would take a generation. Now he may have said "a generation or more," or, "at least a generation," but he said something like that. Now a generation is almost up since that statement, and he may or may not have been right. But he was clearly more aware of the real, huge difficulties facing change in Russia than many of the foreign advisers flocking into Russia and saying that this could all be done quite quickly and relatively painlessly.

They were undoubtedly more technically equipped than Abalkin, who had the old-fashioned broad Marxist left-wing training behind him. The other example is perhaps a less conspicuous, less well-known one. Again, around '91 and early '92 a number of people were advocating a so-called "grand bargain," in which the West would fund upfront – give a substantial contribution to – major change in Russia, without asserting conditionality, just put the money up there, and give it an impetus to start. I remember that Richard Layard was one of those advocates and Jeffrey Sachs was another one. Now, at the time Alec Nove was writing letters that were not published at that time but much later. These were entitled "Letters to Morgan Stanley," in which he was advising them on what was happening in Russia. He cautioned very strongly against the "grand bargain" idea. Basically, he said, because the country is so lawless, that all that money will just reappear in Swiss bank accounts in no time at all. As I say, it was not published at the time, and is not a widely known bit of intellectual history.

I give you those two examples for what they are worth. I ask whether they are very inspiring examples. Do they give us a glimmer of a way towards a much better, more inclusive, more substantial, more wide-ranging science that will unlock some of these problems? I am not sure that they do.

However perhaps a gloomier view even than Stefan: I rather like the idea that major turning points are, if analysable at all, maybe analysable only in terms of chaos theory. You have a highly intricately-composed mechanism that has quite a number of vulnerabilities, and some very small change somewhere will trigger major upheavals. And it is almost impossible to predict those changes. You may have been saying for years that the Soviet economy was in crisis; but spotting when, and what form it would take – I do not think anybody managed to do that.

So this notion of chaos theory lets a lot of us off the hook. "It's impossible to predict these major upheavals – they just happen!" The butterfly flutters its wings somewhere and all these changes follow. I am not saying that that is the end of the discussion, but I think we cannot be too optimistic about solving the problems that Stefan draws attention to.

Stefan Hedlund: Well I obviously agree, in fact I do not think we disagree on anything substantially here. I also remember Abalkin and the others; but I think the distinction there was that they were possessed by much more common sense .

Philip Hanson: Yes!

Stefan Hedlund: ... And that is one dimension, not being a diehard ideologist, but having more common sense that this is incredibly more complicated than you think. That is true, but it is not very helpful.

Philip Hanson: No. Well what I am saying is, is there something that is very helpful out there?

Stefan Hedlund: I think that if we are going to rescue something out of this, we need to formulate it as follows. If we deregulate, and we do believe in deregulation, which is opportunity. You face the economic actors with a new set of opportunities, and the question is: how will they react? Opportunity and self-interest is the core of the liberal tradition. If you give people opportunity, they will act according to self-interest, and they will not be irrational. I get very frustrated when people say that the Russians acted very irrationally. Anybody who is not clinically deranged acts rationally, based on values and beliefs. The problem is do we understand it? When it looks like they are acting irrationally, it is because we have failed to specify their values and beliefs correctly. But I do believe if we maintain rational action as the main parameter, then the problem is whether the theory captures how we understand self-interest. In the liberal tradition, self-interest is the golden rule and all that. But the core question is this: if people have opportunity – driven by self-interest – will they act according to a value or will they act in various predatory fashions? There is not a single answer, but I mean where is the *schwerpunkt* going to be, as the Germans would say; will the majority add value or will the majority asset strip and act as predators?

I think what we need here is to deconstruct civil society, trust, social capital, and all these labels, into three categories. One is, what type of expectations do people have; what do they think others are going to do? They will adjust. If everybody else is going to steal, I will be a sucker if I am the only honest guy left in the room. So expectations: that is something that you can probably work out. The other is what type of belief structures do they have about what will be the outcome; what type of system is emerging here; what is my belief about the function of agencies? It is a little bit more complicated than expectations. And at the deepest level: what type of values do these people have? Here we keep hearing that the Russians are different in the sense that they are not ready for democracy, and as Putin said, a super-centralised state is in the genes of the Russians, and all that nonsense. But it must be true that across cultures people have different values about things like income distribution, about whether the state should be strong, or governed by plebiscite: very fundamental things that make the clock tick. Sections of the population will have different values about what is right, just and proper. Those things really need to be factored in if we are going to understand what happens when we open the sluice gates, and see which way the flood will run. I think if we encourage some more co-operation across what Doug North calls "artificial boundaries" that have emerged in the social sciences, then we might learn a little bit from each other. I do not think that we are going to reinvent a social science that will help us avoid these problems, and if you read Kindleberger's *Panics, Manias and Crashes* you will see how these things will keep happening, obviously. But maybe we can devise a little better understanding of how to reduce harm when they do happen.

John Moore: I think we have plenty to talk about. I have four names on the list at the moment: Krassen, Silvana, Bernard and Tomasz; in that order.

Krassen Stanchev: Well, thank you for both presentations. I wonder to what extent the overall theme – the overall topic of transition's failures and successes – depends on some epistemological assumptions. So, the assessment of failures comes from some sort of concept of transition which would not be successful. So there was no theory of a successful transition. What was available as an experience was the inflation crisis after the First World War; the Erhard reforms in Germany; capital controls /country defaults in Latin America; transition in Chile, Spain and Portugal as some kind of a political process – not so much economic. The common denominator from all these recovery experiences was fairly simple. It was that countries need some kind of sound money – fiscal responsibility prioritisation, delayed denationalisation before that, and some kind of system that reasonably secures contracts and property rights.

So here we have this epistemological situation is like a dog – from time to time it barks, occasionally it bites, and so on. And when you compare the notion of the dog with any real dog, there is always some sort of a deviation, or some kind of a disappointment. The same with the theory of transition – there is no theory, there is some kind of common sense, but certainly there is a *quid pro quo*. We take some kind of an ideal, and we try to compare this ideal with the individual countries. We end up comparing the system of values, human nature, greed, self-interest etc. with some sort of a standard that should have been working without any frictions, and I think this is a very important point. Looking at a distant point from the actual things happening in different countries, I find this system of failures – sense of beliefs and that sort of stuff – quite easy to explain from the empirical experiences of those countries and the people who were involved in the choices made on a political and everyday level. Here there is not so much space for a general theory; it is more an exercise for historical research or for reflection. Most, for example Goldman Sachs and Gazprom, are simply examples of different sources of trust emerging on the decision-making level in these countries. So whether it will be Goldman Sachs or Lehman brothers is a matter of accident. What was not a matter of accident in Russia, is the source of trust which is rooted in the KGB history of some of the elected officials.

Silvana Malle: I think that Stefan, in his paper and also in what he said today, presents much of what we all think. There are doubts about economics – the value of economics; how we transfer economics into policy, and whether the two are in parallel or whether there are too many contrasts. By this I mean that economics, as it is now at least, is not up to the task.
These are all concerns we share. The one thing that I would like to introduce as a problem is that people say that liberalism – or liberalist economics – has become increasingly normative. We tend to accept for granted certain rules and certain policies and we do not discuss them. They are held by a certain "rule of heaven" somehow.

In part, that is true – and I reiterate Stefan's concerns here – young scholars in particular must accept certain approaches, or there is no money, there are no funds. But in part I have to say that over the years, and also working with the OECD, I have seen something that goes against what you say and also what I would be inclined to think. There are a number of analyses and doubts that do not come to light, even from international organisations, where people are doing very serious work and working very hard. It is not that they are not discussed, it is just that they do not come to light. Why? Because of the veto from bureaucrats of leading countries around the table, many of which are countries the participants in this seminar belong to. I am not referring to Italy , which is not considered a leader but a piglet! But to other countries whose representatives are adamant in saying: "Look, guys, you cannot write this." Draft reports are discussed by the committees at the OECD, where all the countries are represented. The debate concludes with a sort of command to OECD economists: "you

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cannot write these things; this is not our policy recommendation" . Well, this is politics, not economics.

On the question of whether economists are able to predict things – I agree with most of what has been said here; but I would be less pessimistic. If you use these humble analytical tools of economics today, we are not able to predict when, as Phil rightly says. Many are not able to predict when; even in physics, geology and the other natural sciences, it is not only us economists. But the fact is that we can, with some grounds, predict that a certain system is not sustainable – we got that at least! Again, I take an example from my OECD experience. In my division, unsustainable growth in Argentina was discussed years earlier than it happened. We warned the organisation and member countries that the fixed exchange rate system of Argentina could not be sustained under growing twin deficits. We kept saying this, and were continuously told not to report what could become a self-fulfilling prophecy. You cannot write about it, otherwise it would happen tomorrow.

So, that is an argument that I would put in favour of "rude economics." We have the economic tools that help us understand economic developments, people are doing their job; but sometimes they are prevented from exposing things. I am talking here of international organisations – this does not have anything to do with independent scholars, where the balance between your argument and what they can say is more tricky.

What also interests me in this presentation is what Stefan said in his paper, and what John says. On the question of transfer of institutions, culture and background for transfer there is a massive literature, beginning with Douglass North and like-minded scholars. I agree that we should understand the cultural background better before issuing any policy or institutional recommendation. For instance, the fact that the Chinese, as a psychologist friend of mine noted, do not believe that truth can make a difference in their perception of policy mechanisms. Believing that there is no substantial objective truth makes a tremendous difference between our Western culture, which seeks outcomes, and the Chinese, who do not trust pre-determined conclusions. They proceed gradually by experiments one step forward and one step down: yet, economic performance is overall impressive.

On the transfer of institutions I would mention Dani Rodrik. Years ago he discussed the Washington Consensus and how this was implemented; as well as the two types of Washington Consensus – before and after the first years of transformation to market!
Rodrik suggests to look first at the types of institutions that already exist in these countries and trying to understand their performance. But to conclude on the issue of institutions, I want to pay our friend Steve Pejovich the credit he deserves. Steve has written prolifically on institutions and informal institutions, and how these informal institutions are *important* in society, because these are the real glue of society. They are spontaneous and people relate to these institutions, until they become formal – once they become law – or never become formal. Comparing these informal institutions with the formal institutions that are inflicted on us by government is instructive. Finally, Steve's concept of "pathfinders" in institutions is

heuristic. Pathfinders are people who feel constrained by existent institutions. If institutions are the glue of society and not all individuals like them, some people will struggle to get out of this glue. They will try to do something else, fighting the existing order until new institutions those emerging as a result of these pathfinders] are accepted by society.

So, there are a number of practical and theoretical issues in economics that we should keep in mind. The ones I raised should be understood not in contrast to, but as an addition to what Stefan has expressed so excellently.

Bernard Brscic: Economics is not only a dismal science, as Thomas Carlyle said in the nineteenth century, but I think at the moment it is also in an utterly dismal state.

The problem with economics – at least mainstream, neoclassical economics – is that it became completely irrelevant. So how did this happen to a very interesting science that originated in moral philosophy until the end of the eighteenth century; then transformed itself into political economy, which was extremely relevant in the nineteenth century. But there is this unfortunate turn in the twentieth century: the loss of the political objective, and the transformation into pure economics.

The other problem with economics at the moment, in my view, is not only epistemological, but it is also ontological. That it simply perceives reality as a kind of reductionism; that it deals only with *homo economicus*, and does not see that human existence transcends market transactions, and therefore the infusion of informal institutions, of values, is of utmost importance at the end of the twentieth century.

Now of course one of the problems of economics is also that it lacks modesty and Socratic wisdom. We basically have a problem with economics that we are influenced by the view that the task of science is prediction. The wisdom of our forefathers, Adam Smith, David Hume and so on, was much more modest. They perceived reality as populated with individuals that are lazy, bounded rational. Then because of this epistemological twist in the twentieth century, we became somehow obsessed with hyper-rationality, substantive rationality, and the view that it is not the task of science to explain things, but rather to predict things. I think that Milton Friedman was to some extent guilty of a major epistemological blunder. That it is the task of science to yield meaningful predictions. That it has nothing to do with truth, nothing to do with explanation; but as long as theory is an instrument – an instrument conducive to meaningful predictions – that is fine. I have always liked to connect Friedman's dictum with Deng Xiaoping's view that is it does not matter what colour the cat is, as long as it catches mice.

Now the problem of modern economic theory in my view is that it does not catch mice, because it is totally hopeless at making predictions. Why is that so? Well to some extent it is because it had a flawed social ontology and to some extent it is because it has a flawed epistemology, and also to some extent because it became a rather immodest science.

Economists think that they know things, and that historians and philosophers know nothing. We are the kings of social sciences, and now the problem is that the emperor is quite naked, as the current crisis shows. The problem is that mainstream economics does not see the reality comprised by certain salient characteristics. What are these salient characteristics that are not conducive to model?

First of all there is a problem of uncertainty. Of course neoclassical economics tries to deal with uncertainty in a rather shrewd manner, to reduce it to risk, which can then be manipulated in models. But of course we do know that uncertainty cannot be equated with risk. There is a problem of time, and there is a problem of knowledge. It is true that major advances are being made within the theory of knowledge within economics, but in my view the school of information economics just does not get, for example, the Hayekian message of dispersing information. It is not all about asymmetry of information. So because of the problem of uncertainty, because of the problem of time, because of the problem of knowledge, we deal in economics with so-called "open systems." Open systems that are not conducive to making exact predictions. And because we do not only deal with uncertainty, but in a sense with relative uncertainty, we cannot know the future. Then one should not be surprised that any attempts at making exact predictions are a failure.

Now this does not necessarily mean that all types of prediction are futile. I think that Hayek was right when he championed the so-called concept of "pattern predictions" – that we can in a sense make certain qualitative predictions, as I think Silvana rightly mentioned that some Sovietologists predicted in a patterned way the collapse of the Soviet Union. Some failed. So it is not a complete failure, but if one would possess an adequate epistemology then one would know that dealing with an open system creates enormous problems for prediction. I think in methodology we should return to another task of economic theory, which is explanation. In the field of explanation there is major space for economic theory, and also we should abandon positivist instrumentalism, and its denial of truth. I think that this methodological nihilism – of economic positivism – is extremely harmful, because without truth, without the quest for truth, I think there is no real science.

So my point is then that economics should return to its roots, to the patron saints of the Scottish Enlightenment. I will not say that it is all in Smith, but in a way I think that the research programme of classical political economy; which perceives political economy as a kind of plutology, as a science of wealth, is a worthwhile project. I think that some return has been done within what is to me the most promising research programme in modern economic theory, that is New Institutionalist economics. New Institutionalist economics poses the right questions: what is the wealth of nations; what are the nature and forces of the wealth of nations, and in that sense we also have to redefine the methodological stance of economics. This does not mean the abandonment of economic modelling, or the demathematicalisation of economics, but one has to concur with the assessment that mathematics is a good servant but a bad master. The problem for modern economics is that mathematics became a master that defines the research questions.

Bob Reilly: I have a comment – if it is the right time to offer just a gloss on what Bernard has said; which is actually another way of saying why I like Stefan's paper so much.

To go back earlier than Adam Smith, perhaps back to Plato and Aristotle, who said that the order of the city – the political order of the city – is the order of the soul writ large, and if you have a disordered soul, you are going to have a disordered political order. And since the economy is part of the political order, that disordered soul is also going to produce a disordered economy.

In what sense? Precisely in the sense that Stefan was talking about. Are people going to asset strip, or add value when they are given an opportunity? And the disposition of their souls is precisely what would lead you to the answer of what is going to happen in a situation like that. So the economic situation is derivative of these things and not independent from them. That I particularly appreciated in your paper was the number of times – without putting it in terms of classical political philosophy – you made that point, whether you use culture or morality.

I will just refer to one point you made in this paper from Elster, who said that morality and social norms seem to count for more than enlightened self-interest. However, that sentence is a tautology. The very definition of enlightened self-interest is self-interest informed by morality – which of course in the case of the founding of the United States was the *sine qua non* for that new political enterprise. The condition for its success was the self-enlightened understanding of its citizenry, and without which it could neither have that political order nor the derivative economic order.

Olga Kuznetsova: I wondered how this applies to rationality. I liked your paper, because it is so much in line with what I think.

My question is why the specificity tends to not be recognised, because it looks like we understand it. For example, in light of the Russian historical experience and financial institutional configuration, it could be argued that the Russian economy as a system is more pre-disposed towards a co-ordinated type of market structures. Although invariably from day one the political and economic reforms were conducted with the philosophy and the framework and conceptions of liberal economy. Everything has been borrowed from the United States, and I understand that one must always sing to the tune of those who pay – maybe that is the reason. But they took all these liberal capitalist values at face value, and that is how they tried to conduct the reforms. So now we are talking about state capitalism, possibly, or the signs of state capitalism, in Russia; and there are some signs that give an impression that Russia is turning back to progressive marketisation. But possibly in reality it is only trying to implement a system that *is* compatible with the institutional setup. I do not know whether there is a deliberate cause on the side of the authorities; or whether it is just a natural progression that we are seeing. What would be your comment?

Stefan Hedlund: I will answer that at the end of our discussion.

Tomasz Mickiewicz: I have this British instinct that when I see a series of people criticising something, I have this urge to respond on the opposite side. So as much as I sympathise with quite a lot of what was said, I would like to make a case for some optimism, and for economists and the crisis.

The problem is that success is very difficult to notice. And effectively when you think about the current crisis, what was the defining point of economics for the last two hundred and fifty years? The defining point was basically that free exchange produces value. So, now when you take the current crisis, and you think about the historical experience of the 1920s/1930s, what happened immediately at the end of the 1920s was simply that free exchange collapsed. There was a wave of economic nationalism, and foreign trade collapsed, exchange collapsed, which we do not see this in the current crisis. And this is the major success of economic thinking. The problem is that we do not notice it because we take it for granted, but it is there. I would say that economics actually proved quite successful. Of course crisis happened – there is no question. Crises always happen; that is the definition of crisis: something we do not expect. I doubt whether we would ever be able to, because crisis is triggered by change and we need change; it is the price we pay. This is the cultural determinant view. The crisis is the price we pay for change. If you trace the current crisis much of that can be attributed to the fact that technological progress was so fast that the institutional environment could not catch up with the technological development in the financial sector. You can trace some of that to this.

So this is the price we pay for development. It is an illusion – and I would say that it is even a dangerous illusion – to fixate on how to avoid crisis; because the price we pay there is slower development.

So that is in defence of crisis. Now secondly, what I am hearing here is that, as hinted by Bernard but I would like to emphasise this point, what we need is political economy. I do not think – despite the current nonsense going on in macroeconomic policy discussion – that this is the major issue in what is going on now; that this is the major problem. The problem is that we need to analyse the behaviour of politicians, and it is better to ask the question this way: to question which institutions are more conducive to better policies. The mistakes were not made by economists, but by politicians. The fact that politicians panicked after the crisis, and then spent too much money through public aid, gave too much money to the banks. Before that, in Britain for instance with which I am more familiar, there is the whole issue of support for the financial sector. In Britain we seem to be proud of the fact that the country never had an industrial policy. In fact, Britain had quite an inefficient industrial policy for quite a long time, which was simply to give special favours to the financial sector. Full stop. And where is this coming from? It is not from faulty economic theory, but the fact is that politicians love to have funds and power; and it is great to deal with people who provide finance, and then to strike deals with them. So the real question – and this is one of the questions of New Institutional economics – is how to design institutions that address this.

One important lesson is basically to decentralise. This is one option that was mentioned by some other people. By decentralising, you are making the stakes, at the central level, lower – and that helps, that is more healthy. What is now going on in the United States is so unhealthy because the stakes are so high. Why are the stakes so high? Because the United States became very centralised, and the federal government too powerful. This is not how the US used to be, but because the federal government can now do so much the stakes are very high in elections.

I sympathise on this issue of informal institutions, but I am also a little sceptical, because I think that institutions can be transplanted. Again, just to balance what has been said, I do not think that we need to say that everything is different; that the Chinese are different and so on; we will wait and see. China is still a lower middle income economy, and we can discuss it when it becomes richer. China is now in a phase that it does not need the institutions that the US or Europe have. We need to see what will happen next.

Now, there are least two well-known cases of institutional transplant that go against this theory of difference, one was Germany and the other was Japan. Germany had a federalist system imposed on them by the Americans, and it worked well. Japan was opened up and it produced the most spectacular case of development that we have ever seen. I would say the same about Central and Eastern Europe: those countries that went further importing the full set of institutions did better and not worse.

Philip Hanson: I just wanted to contest what you said about crisis being unexpected. The whole thing about crisis, as we know it, comes from medicine in which the crisis is the turning point in an illness where the patient either dies or gets better. That does not make it unpredictable. And if we could do the sort of thing that you are advocating – that is, predicting the behaviour of politicians – we could also predict the crisis!

Tomasz Mickiewicz: Well, not predicting the behaviour of politicians, but making some of the dysfunctional behaviour more difficult. And also planning the crisis, in terms of building is the critical issue. You can plan for the crisis, but you can never say when it will happen and I would still subscribe to that. You can plan for the crisis, instead of being reckless in your fiscal policy. You can build reserves.

Philip Hanson: Yes, fair enough. I just wanted to raise one further point on the whole business of institutional transplants. I think that the post-war history of both Germany and Japan is open to a wide variety of interpretations. It may be that the essential institutions were already in some sense there. And bear in mind that Japan remained a one-party state for quite a long time – a *de facto* one-party state.

John Moore: By the way, I do think that there were a lot of people in the US who were predicting that there would be a crisis. They did not know when, but this very long policy of easy money, practically zero interest rates, was bound to create a crisis eventually. I think that a lot of people saw that, but they did not know when.

Silvana Malle: Thank you for saying that, because I was going to come to this point concerning the United States, but also concerning Europe. When the Euro was created there were a lot of economists who said that it would not last. Now it is collapsing. Of course we can debate that in economic terms, but also in political terms, because the two things are always connected. If politicians keep playing certain games, it can accelerate the collapse or it can delay the collapse. But the Euro area is in a state of collapse, which nobody can deny. So that *is* the interpretation of economists; at least those whom I consider to be the best economists that I am reading on this matter.

Very briefly on decentralisation – whilst in general for modern democratic economies I would share this opinion on decentralisation, which is in part what Stefan was saying. It has become a sort of norm. Fiscal federalism is good. Now. It is not good by itself. We have tried in Italy, where we have created regions and so on. The whole regionalism agenda in Italy is a terrible waste of resources. Italy is still a country that needs a centralised state with better people at the centre, but that is another story! But a centralist state would reasonably transfer resources here or there; and when it is better not to transfer them, then not to do so anymore. The head of one of our best regions, is Aosta – is paid *more* than the President of the United States! By whom? By people like me.

John Moore: Well he is probably worth it!

Krassen Stanchev: I agree with Phil's point, and I would like to make an additional one. So if someone – and this is to show the transfer thing – is to stick to paths and history, then which part of history do you take? I remember Nikita somebody who said in 1762 about Russia; that in Russia those who cannot plunder, steal. So you take this tradition, and what do you do with this?

Stefan Hedlund: On the question about predictability, I want to argue this more substantially with Silvana in a while. But just a personal reflection; in October 2008 I met the Head of either Fannie Mae or Freddie Mac (I will not say which!), at a conference in Bangkok. I asked him: "I mean, didn't you guys see it coming?" And he said "No! All the graphs, all the corridors were pointing upwards. If I had seen it coming I would have got my rear end out of there in time!"

I am not convinced that people really see these things coming. It is one thing to say that we know that the Soviet Union is going to collapse in the next thousand years, but that is not very helpful.

Laszlo Csaba: If I listed all the merits of Stefan's presentation, it would be a long list. I liked it very much, on a number of counts, and I think that it is on the intersection of area studies and general economics, and it contributes quite importantly to the development of the discussion contributions. I would like to comment on what he has to say on the global economic discipline. And to make a long contribution short, I would just recall a quibble of my former Professor who says that economics is not just a dismal science, but economists are dismal people. And we are dismal people for the simple reason that a proper economist does not follow what he learnt from the textbook; that when times are normal and everything is fine then you feel secure, whereas in unusual times when everyone is fearful then you are also fearful. So you are just like anybody else, and therefore need a justification for your professional qualification; the reason why you are being paid by the public or a private company.

So, a real economist is a dismal person who fears comfortable attacks on prices. Because then we have an opportunity to check all our theories and to see why they do or do not work, and develop their wants. This is true when you think through the history of economic thought, which has disappeared and has unfortunately been extinguished from the curriculum of most serious universities, including the Central European University and Corvinus University. Then of course we all have a tendency to forget that certain things have been said before. I was very happy to see this book out there in the break by Ludwig von Mises who said a number of things that we are saying nowadays, in his two seminal books on human action and the epistemological problems of economics. He basically stated what would happen if economics dictates the terms, as we are currently seeing in the mainstream and he said all this in advance.[2] And we should not close our minds, at least those of us who still remember the theory of economic thought. There was a big clash between those who followed the more Schumpeterian lines (von Mises, Hayek and so on), and those who were much more of the mathematical school, the general equilibrium school, which has become the mainstream since the 1960s and the 1970s. It is no secret why they became the mainstream, because that was the time when "the democratisation of higher education," took place, and if you have large student numbers you cannot get along with von Mises. All the speculations, arguments and counter-arguments and how some of the sentences may not have translated well from German into English so you need simple mathematical formula. One you can check and apply and then you are done. It is very ethical, and this to a large extent explains what we have seen. If you have a simple solution and you apply it to a difficult situation, then of course you get the outcome that many people have stressed and I will not replicate. I would just mention that many of these ideas have been around, and fortunately still are around and can be found, although there is a systematic extinction of this type of knowledge. Axel Leijonhufvud, one of John Maynard Keynes' surviving students, wrote an article once – I think it was in Western Economic Journal – entitled "Life among the Econ." It begins: "Economists are the only tribe where not even the beasts are cultivating the memories of the good old days." This

[2] Ludwig von Mises "Notes and Recollections", Foreword by Margit von Mises

I think is one of Leijonhufvud's many important criticisms, which explains the state of economy if you have no memory, let alone institutional memory. Let us institutionally cultivate it, then you are completely ignorant. Then you are prone to reinventing the wheel, which has happened and which is actually highly decorated by Ludwig von Mises and many others in the profession.

I do believe that there is a need for soul-searching, and the type of initiatives that have been suggested by Stefan are moving in the right direction. Of course it will take a long time, because we have so many students and actual practitioners who have been trained the wrong way. Think about the change in the genre of the opera – in the early nineteenth century you had all the Passegiati who had something to say, but only certain genres to sing; and then came all these crazy people – Puccini, Vivaldi and all the Italians, and of course Wagner. They had men and women struggling in the scene together, not really caring how long they can keep the high C. I mean those whose only contribution to the field was to keep the high C endlessly were of course fighting back. This is what we see, and will continue to see over the next two decades in the economic departments, which are populated by species who are only able to deliver one type of genre.

I think this is quite important because then we are back to discussing which type of change we need. Similar to the opera of the nineteenth century, we must come closer to the public, to be more relevant, more interactive with the public. Do we need it to be more political economic? I think we really have to make some fundamental changes. I mean if we are these small people who feel well in times of crisis, then that is a very difficult agenda. As Bernard said, we have to be more modest. We do not necessarily have to predict, but we have to first understand what is going on. We also have to be modest enough to say that there are limitations to what we can understand. In order to do that we may still have a political theory rather than a given appropriate methodology. We can no longer afford axioms that are obviously contrary to the findings of our discipline.

I am thinking about rationality being the overriding determinant of human behaviour; everything we know about sociology, neurology, biology, let alone everyday observation. I mean do we make decisions about marriage and divorce on the basis of rational calculation? I do not think that it is very realistic. So one way or another, history and institutions and knowledge from other disciplines will have to be fed back to our ideas of man. That will perhaps help to explain what Stefan quite correctly pushes; how norms and values are being fought, how ideas are being fed back to the decisions of individuals in a completely observable fashion. It is not coherence that we want to check, it is not that we want to put a number on something. We want to understand what is happening and to do so we have to go out and watch people and ask how they make their decisions. It is extremely interesting; those who do this rather old-fashioned empirical work come to completely different conclusions than could follow from microeconomic assumptions. These are not assumptions, but something that you can test on the ground, just like in biology, physics or chemistry.

So I think there is a long way to go; to restructure our expectations, our models, our ways of thinking, including whether it is the only successful criterion that you can put a number on something. And finally – on a slightly unrelated topic – what is success and what is failure? Of course that could be a subject of a conference, but I will try to be briefer than that. I hear that transformation is a success, which is of course true if the question is whether a communist economy can be transformed into being more like a 'normal' economy, right? If – recalling the people of Valencia – the fish soup can be turned into fish. Yes, if that is the standard then we were successful. But if it is more like developmental success, then I wonder whether we can talk about success. As for developmental success in the sense of and many others such as Chile, I wonder whether it is a success.

In the break I looked at this Chatham House publication, *Putin Again*, and read the contribution of Lilia Shevtsova "The New Russia's Uncertainty: Atrophy, Implosion or Change?". I mean I have not read it yet, but it does not sound like a kind of report of a victory![3]

In terms of China, people know that an asset bubble is in the making, a banking bubble is in the making – even official rates of growth are about half what they used to be, and what official economists consider to be necessary to sustain the communist system. So I think if you wish it is like a kind of pornography; a mirage. Success is observable; it may not be possible to define what success is, but we can see when it is there. We can observe some success in the Baltics, Korea, Chile and so on, but there is not so much elsewhere. We have to remember that this is the post-communist era, and that when diazepam has been taken for a long time, we will need to understand the problem properly before we can prescribe any medicine.

Silvana Malle: Just a quick observation on this issue of literature addressing the crisis – you may be right in the fact that you do not find articles in the major economic journals on the crisis. There is still time as these journals take time to produce. I know that from my own experience in publishing an article that took a couple of years. So economists, like other people, are publishing their own analysis in other ways. Thanks to Richard who alerted me, almost every day I am exploring Project Syndicate, a site on the net whith articles on the crisis by major economists on what is happening in China and other areas of the world.

About prediction – 'the doom and gloom Dr.' Nouriel Roubini should be mentioned, because he predicted everything. Credit should be paid not so much to his prediction, as such, but to the underlying analysis justifying that prediction. You can predict something but your analysis is completely wrong! That sort of prediction I would not take as being very valuable.

[3] *Putin Again. Implications for Russia and the West* by Philip Hanson, James Nixey, Lilia Shevtsova and Andrew Wood. Chatham House, February 2012

So I would advise here that people get to know more about what is available on the Net; see what is being produced in a number of forums on the crisis. There is Simon Johnson, the former chief of the IMF, informing regularly and it is very interesting to see what he has to say on the Euro crisis and so on. Some years ago Rogoff and Reinhart wrote a marvellous paper where they examined all crises that have occurred over the centuries, to see similarities and the differences. Their policy recommendations, thank heavens, are on the liberal side.

Karl-Peter Schwarz: I think that sometimes it is necessary to reconsider our own cognitive conditionality. We were all used over the last twenty-five, twenty years to sudden, deep, and very radical changes. And maybe we underestimated during this time, the importance of the forces of inertia, of the things that do not change in a few years or in the life span of one or two generations, we underestimate what Braudel called the *longue durée*.

I remember Richard Pipes´ wonderful book on the Russian Revolution, in which he describes in the first chapter the situation in Russia before the revolution. If you confront it with what we read and hear now about Russia you will find many analogies, among them the high level of corruption, the inertia of the bureaucracy and the high transaction costs.
We should not consider what happened after communism and what happened during communism, but also what happened *before* communism. The new political classes in the transition societies emerged in the course of the nineties heavily influenced by the cultural patterns rooted in the history of those societies. Even if they had the perfect textbook of economic transition, this would not have profoundly changed the course of events in these countries because their understanding of the transition was already conditioned by those cultural patterns.

The mos important of those patterns is *dirigisme*. It not only shapes the political expectations of the policy-makers but also shapes the expectations of their victims, of those who grow up with *dirigisme*. I once met a young entrepreneur in Prague who finished university in '89. We students had incredible possibilities for our careers, he told me. We talked about who of us would go into politics and who would start business, and that we would support each other and build up a strong network. This cultural pattern was quite familiar for everybody, because it was like this under communism. It has a lot of advantages because it limits the risk of competition.

We should not expect too much from the younger generations. Yes, they have westernised themselves; they study outside their country; they travel to Europe, to America, they introduce new elements in their societies when they come back. But their behavioural patterns are not so different from those under communism. What happened in the nineties was a synthesis of contradictory tendencies. On one side, a political class embedded in the political traditions of the country and the dominating value system of communist and/or pre-communist origin. On the other side were reformers who thought that switching from command to market economy would automatically put the things right, which was in a way itself a reversed Marxist concept. The outcome was a kind of state-run capitalism, of politically-guided corporate capitalism, crony capitalism, which is here to stay. I do not expect it to change, at least not in our life span.

Finally two sentences on rationality. What do we mean when we say that man is behaving in a rational way? He behaves rationally because he wants to achieve his aims in a rational way, step after step. But this does not say anything about the rationality of his aims or of the rationality of the world as such. The actions of Al-Qaeda for instance, are perfectly rational; it was perfectly rational for their terrorists to kill the American Ambassador in Benghazi. Whether the goal is rational, and whether it makes sense or not, is another thing entirely. Do politicians behave rationally? Yes, they do. But who says that they want an unhampered market economy. Who says that they want a society based on freedom, property and prosperity. Why should they? They want to maintain their coercive power, they want tax payer´s money and they want all the privileges of their class.

John Moore: Thank you. Bob did you want to say something?

Bob Reilly: Yes, Karl-Peter I would just invite a distinction there, in the way in which you express these things. Al-Qaeda does not behave rationally; they behave logically. *A paranoid* schizophrenic behaves logically, but not rationally. And the distinction has to refer back to whether the person is in contact with reality, and whether his presuppositions concerning reality are true or are not true. In other words if you do not make that distinction, the term 'behaving rationally' becomes useless, because everyone behaves rationally in that way.

Karl-Peter Schwarz: Economic theory does not distinguish between logic and rationality as you do.

Bob Reilly: Well, perhaps that is a problem.

I would just also add that the nature of the thing that is pursued has to be understood rationally. In other words, with some relationship to reality, as to whether it is good or whether it is evil. I mean if you do not do that, then what is the worth in knowing anything else?

Bernard Brscic: Well in economics, Bob, things are pretty straightforward. There are three assumptions which must be fulfilled; which is completeness, transitivity and inflexibility of preferences. I would agree with Karl-Peter, that actually Al-Qaeda is a perfectly rational organisation. What one has to distinguish is what Stefan actually pointed out in the question of beliefs, and perhaps the term of the reasonableness of beliefs, the relationship between the beliefs and reality is what matters. And in that sense I would agree that actually the flawed ontology of Al-Qaeda is that their beliefs just do not fit the facts; but otherwise they are perfectly rational.

Richard Connolly: I must apologise because I was going to make these points about an hour ago, and now a lot of people have made them for me I think. So I might be going over a bit of old ground, but hopefully I will make some relatively fresh ones.

I am just going to pick up on this point about the economists predicting the global financial crisis or I guess any big event. Because of course there is this famous example of the Queen asking "Why did nobody see this coming?" and Robert Lucas replying, "Well we couldn't have seen it coming, it was impossible." Well of course people did and some names have been mentioned: Silvana mentioned Nouriel Roubini; but there was also Robert Schiller. These are some famous, reasonably rigorous economists. Roubini worked for the IMF, the US Treasury, New York University, so I think that we could classify him as an economist. As Silvana pointed out, he made his predictions based on good theory. His experience with financial crisis meant that he could look at maturity mismatches in funding, capital structures, the way in which the current account was decomposed, and credit growth. All this was for me pretty rigorous thinking, and he was bang on about it. You are correct in that he did not quite get the time right, but he said that this would happen and that it would happen in the US. He also pointed out why it would happen in Central and Eastern Europe. He also pointed out why it was going to happen elsewhere in Europe for different reasons, and in fact there there was public debt in some countries; and in others like Ireland and Spain it was based on financial sector growth. At the moment in China, for example, there are some, Michael Pettis – I share his views with Silvana – is making a lot of points. Again, these are based on good rigorous, I would say, use of economic tools, to say this could be a really big problem.

It seems to me that economics does have the capacity to predict things, and to get things right. So I think we should be slightly wary about throwing the baby out with the bathwater in criticising it. But what is important, it seems to me, is not necessarily whether economics has the capacity to predict these things or to analyse or explain things correctly. Rather, it is whether people want to listen. This is where we come to interests, and this is where politics becomes important. If you look at the run up to the recent financial crisis, and look at, let us say, the public sector, the corporate sector and the household sector – whose interests was it for this continued credit boom to keep on going? I mean if you look at the public sector, politicians – increased tax revenues they can use for their own purposes, to buy support elsewhere. Also if they do that, that buys them a new election; fantastic. So the public sector has an interest in sustaining this credit boom. The corporate sector: increased profits, massive bonuses for people, particularly when you have this sort of shareholder capitalism we now have in the Anglo-Saxon countries. Again, they have got an interest in sustaining this. The household sector: in Ireland, in Spain, in the UK, in the USA, house prices were going up; people were making money without doing anything at all. I had a lot of friends who did this, and they thought that they were really clever, really smart people, who suddenly became middle-class through simply getting a loan.

So all of these people have an interest in this belief system that became, I guess, embedded over this period of time. They did not want to listen to people like Roubini and Schiller saying, “Look we are creating an edifice that is going to topple over here.” They selected, they appropriated, the bits of economic theory that justified their lives, that justified their apparent success. For example if you look at pre-2008 – the efficient pricing theory was very much in vogue. Of course it has largely been discredited now. But that was very much in vogue at the time, and used as a response to people like Roubini and Schiller. They would say “Hey, look at this: these problems are priced in, it’s not a problem, everything’s fine.” I guess that my point there – the main one – is that elements of theory were used to justify a particular mode of capitalism. And this is a broader point, but this was a form of *financial* capitalism (or whatever you would like to call it and we could probably come up with a better name) that was, and remains, dominant. And they cherry-picked the bits of theory that supported their position in power.

When we are talking about the failure of economics in relation to the crisis, we are in fact talking about the failure of a particular type of economics that was in vogue, and was dominant beforehand, and also the failure of a particular type of capitalism that used that economic theory. I guess this is getting to the main point now that there was a massive convergence of interests, as I have just outlined, which used the theory in a certain way to justify the world as it was back then. How is that going to change now? Because, as you say, beliefs change slowly and do not change overnight. This is why, in my opinion, we are seeing such a slow reaction. Simon Johnson writes about the financial sector and how it is subverting attempts at reforming the financial sector in the US. But it seems to me that they use, for example, the household sector’s attachment to high house prices to justify their lobbying of government, to dilute and water down attempts at reforming the financial sector. And it works, because politicians also want to win an election. In the UK, for example, the predicted 30-40% drop in house prices next year is not going to do the coalition any good when it comes to the next election. So in that respect they have an interest in listening to the financial sector because this web is still there; it has not disappeared and it has not gone. I think that this spell of the old model, and this convergence of ideas and interests, is something that will take a lot longer: and this is what you talk about when you discuss culture and society and ideas. In my opinion it is going to take a long time for this to change.

Roger Sandilands: I would just like to emphasise that economic theory has lost sight of the classical economic theories of the Physiocrats, and their tripartite distinction between land, labour and capital. When you talk about house price booms and busts, what one needs to focus on is not that the prices of bricks and mortar are booming and busting, but that the price of land is booming and busting. Now land is a very different entity to manmade capital and that classification of economics that looks at economics in terms of capital and labour, without making a distinction between capital and land , has been, in my opinion, highly detrimental to our understanding of the underlying features of capitalism, as we know it.Tthe need to focus on the land element of the so-called housing market, and how speculation in the land market is very different to speculation in bricks and mortar. Because land is fixed in supply, and when demand rises or falls its price rises or falls. When it rises it is a Riccardian surplus that diverts income from the productive classes to the essentially unproductive classes. I think that it needs to be understood in those terms.

But one other name, besides Roubini and Schiller, that I myself would emphasise is that of Fred Harrison, who focused on eighteen-year cycles. His theory was not perfect, but he did see the crisis coming, and he understood on both empirical and analytical grounds – going back to the neoclassical economists – why it would occur.

Bob Reilly: Could I just add something to what Richard said and with which I completely agree, that the self-interest of those various sectors has been key to fuelling this boom. Of course, before that boom began, the underlying assumption in making subprime loans available to these people, through the legislation that directed Fannie Mae to do these things, was based on the proposition that it is a "moral good" to own a house, and that the promise of America is to be a homeowner, not a renter. Now this turns out to have been a fairytale, not a proposition! You might say that this is a rationalisation of self-interest, but it was not really. This was proffered at the level of the "American dream," and had an element of morality behind it.

The second point that strikes me about the United States is that over this prolonged period of enforced low interest rates, savers have received an absolute walloping. And one wonders what the political reaction will be from all those who had an expectation of living off , even a moderate expectation , of what interest rates would give them in money markets. These people have been slaughtered by this!

John Moore [and agreement from others]**:** Yes, very true.

Roger Sandilands: On what Robert has just said: I refer to the Community Investment Act, which was basically morality based. It was the idea that banks were actually required to make subprime loans to ethnic minorities who had been disadvantaged in banking, and if they did not they would be penalised for it. So there was that element to it too.

Silvana Malle: I agree somehow that the savers were penalised by low interest rates, particularly in the United States and maybe also in Great Britain, I am not sure about other countries. However, a lot of pensioners are also shareholders, through their pension funds. So, maybe they lost their saving in the banks, but the US is a country where most of the pensioners rely on the stock exchange, as indirect shareholders through pension funds. It would be interesting to discuss how these particular institutions work and compare performance.

Peter Mihalyi: I would like to go back to the title of Stefan's presentation, when he was talking about the limitations as a successful guide, a good guide, of economic institutions. And I would also draw in Richard, in defending economics as a science. Here I am talking not just about mainstream economics, but everything that is considered by economic research. I think economics is basically well and running, but do not forget – especially in this year of the Olympics – that we live in a competitive world, and I think the so-called "Red Queen Paradox" is a very important element of our lives. Here I am referring to the Lewis Carroll story, when Alice is told that she will have to run twice as quickly if she wants to catch up with the others.

So when we talk about the success of economies, we are talking not just about ourselves as economies but also as people in those countries, in terms of success in relative terms. Whether we in Hungary grow as fast as the Poles grow, or whether Italy grows faster than Portugal or Spain, and so forth. And in that sense there is a competition, like the Olympics, where it is simply not true that everybody can win. So we should not expect that economic policy models are a cookbook guarantee of being successful. Economics is a cookbook in the sense that if you follow the rules you can make an edible fool, which is not poisonous and at a reasonable cost. For example you do not want to put very expensive wine into the tea, because it would just ruin the whole thing, but no cookbook would recommend that!

I repeat, economics is a cookbook for reasonable functioning. One limitation is the "Red Queen Paradox." Doing things well is not a guarantee that you will be the winner. The second limitations is that "geography matters", too. There are countries with very different endowments – and not just cultural though but also geographical: size of the country; whether you are landlocked; whether you have nice hills where there is snow, which always comes free of charge; whether you have sunshine, etc. And some other countries do not have that, and of course that makes the difference. Think about countries like Russia, or Kazakhstan, or Saudi Arabia. Obviously these countries are not pursuing good policies. They are not following the recommendation of the famous cook-book, named Washington Consensus. But this does not mean that something is wrong with the Washington Consensus. These countries are successful because they are extremely rich in natural resources, and hence they can afford the luxury of disregarding the recipes in the cook-book.

I do not think that any of us around the table could come out with an example saying that stupid economic policy works in the long run, unless you are a very, very rich country. Let me end this on a humorous note. Question: How to become a millionaire? Answer: Very easy, if you start as a billionaire.

Silvana Malle: We have mentioned the Washington Consensus more than once, and as I said earlier, there have been two versions of the Washington Consensus. There was the early version that worked from the early nineties, which was conceived initially for South America, and then applied to the transition countries. Then the same John Williamson recognised in a briefing he gave at the World Bank that something was missing from the blueprint of the Washington Consensus. And here we have what was missing; it was institutions. The whole thing was to make sure that you have no deficit, no debt, public debt: things that we know of as basic fundamentals of macroeconomics. But the other institutional part, which included foreign direct investment, did not count. He recognised – brilliantly – that indeed it could be improved. And they improved the second version of the Washington Consensus.

Bob Reilly: Bad economics does work politically and in a sustained way, as we can see in countries like Saudi Arabia.

Peter Mihalyi: Oh sure, sure – but then we have an explanation. That is what I am saying.

Philip Hanson: It would do even better if it had good policies.

Bob Reilly: But better for whom? Not for those who implement these policies to maintain their rule.

Krassen Stanchev: Peter, I buy most of the points that you make, but about this competition thing; I do not think that it works. If it seriously works on development economic theory, it would go back to some sort of Ludwig von Mises explanation of economic processes – some international effort to prosper or to live at the expense of the others. There is not exactly competition, but some countries or some political establishments in some countries pay attention to neighbours. For example Hungary and Poland or Bulgaria and Romania, but it is very rare to have reasonable accommodation for anything.

Peter Mihalyi: No, it is very simple to compare Hungary with Austria. Of course it is the Hungarians that do it. They are judging the Hungarian government on the basis of whether the difference between the two countries has stayed the same or increased. The same in Spain, in Italy or Greece. I am talking about average people, not politicians.

John Moore: I think that we should give Stefan and Phil a chance to respond, and then there may be time for a few more comments at the end.

Stefan Hedlund: This has been incredibly fruitful. I think that there have been two general issues, one is prediction and one is heuristics (of evaluation). If we begin with prediction, where I remain sceptical about our ability to predict – I will take the simplest of all examples, of a Ponzi game. I mean it is trivially true that a Ponzi game will collapse. So, it is incredibly important a. that we understand that it *is* a Ponzi game; and b. that we say something about when it will collapse. And unless we understand what will trigger the collapse, we cannot say anything about when it will collapse. We can say everything about vested interests – the temptation to say just one more day, because the yields are so high, and then I will get out. But of course you never do. So unless we understand exactly what the type of behaviour is that causes people to hang on too long; that blows the bubble up to its immense size: unless we can understand that, we cannot really understand or predict the fate of the Ponzi game. No matter the whistleblowers and so on, it is a game that should have been stopped much earlier.

A more important illustration of the same is the "GKO game" that was played in Russia's financial markets. I predicted that it would collapse immediately in 1996, and I was treated like something the cat had dragged in. I was wrong for the very simple reason that the Russians opened it up to foreign investors. So American financial operatives had the opportunity to pour twenty or thirty billion dollars down the sinkhole before it collapsed. So unless we could see that the GKO market *was* a Ponzi game – which I argued based on yield structures and the way they recycled yields into the value of the GKOs – unless we saw that it was a Ponzi game and unless we could predict how the political establishment would deal with this Ponzi game, there was no prediction. In the end it was two hundred and forty billion roubles down the drain that could have been predicted to my mind, had we been better at that game.

Some people predicted that the USSR would collapse, but most did it for the wrong reasons, as you say. I mean there are all kinds of reasons out there, *Empire éclaté* and goodness knows what, civil war ... all kinds of things would bring down the Soviet Union. But nobody predicted that it would collapse when it did or why it did. I do not think that anybody can credibly argue that. I think what is more serious today, is that we still do not have any consensus on why it collapsed.

Lazlo Csaba: On why?

Stefan Hedlund: Why? Why did the Soviet Union break up, and why did it break up in the way it did? Twenty years have passed, and if we still do not agree on why it collapsed then we cannot credibly argue or predict that it would collapse. If we do not agree on the outcome, how can we say that we have predicted that the unknown outcome would come about? There is a problem there. And I think that this problem also applies to the question whether China is sustainable or not, or the Chinese growth story is sustainable or not. This is not a trivial issue. If China collapses in some sense and there is a civil war or some other horror, then we are all in very deep trouble. So it makes a big difference if we can understand where China is heading and whether it will collapse. Taking the Chinese long view and saying that maybe it will collapse within a thousand years is not very helpful.

The problem I see when it comes to economics and politics here is that it is also so easy for the economists to say "we had it right but the politicians had it wrong." Because a serious policy analysis will have to recognise that politicians are endogenous to the process, and they have to be factored in. We cannot just lay out a technical analysis of what is to be done without factoring in how the political establishment is likely to play fast and loose with the new opportunities that are being created by a reform programme.

So I think that that is also a serious problem. When it comes to yardsticks and whether transition was a failure or not, I think that I began by saying that in my book transition was a failure, judged against the earlier ambitions, and I think that everybody would agree that it did not live up to the promises. Whether then what happened over the next twenty years was "good" for those involved is a heavily value-based judgement. I mean, many Russians would argue that the sort of market economy we want them to have is not in their own best interest, and there are all sorts of beliefs that make this a normative judgement, so you cannot really say that. But what I would argue is that whether transition was a failure or not, really boils down to the question "could it have been done otherwise?" I think that is the real question we should ask ourselves. If you say "they screwed it up!", you really have to answer the corollary question: "what should they have done instead?" I think there is a problem here with the transition industry in the sense that all this happy talk, which was generated by the usual culprits, was detrimental in the sense of opening up the field to *more* opportunity for asset stripping, and predatory game-playing, than would have been the case had the West not been so heavily involved in supporting this neo-liberal vision of a minimal state and grabbing hands. You all know the nonsense that was peddled in the early nineties about how the state was the problem and I think that made it worse. It does not mean that I could suggest exactly could have been done, though I do believe that some harm reduction would have been possible. But essentially it was probably in the system, that it would unravel and produce the type of problems it did.

If we go back and listen to what economists were saying in the early nineteen nineties, it was very hard to convince anybody that taking away central economic planning, and putting in place a market economy, would lead to hyper-depression. I mean, that was not a possible argument in '92, '93 or '94 and yet that is what happened. And then we ask ourselves why, but still there was this problem of economics, normative liberalism. We have sure efficiency gains; it has to improve. When it began to transpire that it was going down the drain there were all these sort of defences. It is a statistical phenomenon; the numbers are wrong; Russia really *is* growing, though it looks like GDP is falling. When they recognised that GDP was falling, then it was falling for the right reasons because they are not making bad things anymore. Now they are making good things, not so many, but a small amount of good things is better than a large amount of bad things. All these rationalisations just hindered the realisation of a major systemic failure in the making.

Leijonhufvud – who brought up Leijonhufvud? I think that is one of the funniest articles I have ever read in an economics journal about "Life among the Econ." And I remember his final sentence in that article: that you have a math tribe, then a micro tribe, then a macro tribe, then a math-econ tribe; and then the loneliest of all the lonely, the Develops, because they deal with reality. So they are the outcasts. The math-econ and the micro and the macro, they make beautiful models or "modls" as he calls them. He ends this story by saying "today we view how modl-making has achieved a status of aesthetic sophistication we have never seen before. Yet, it is very doubtful if this gives any reason for optimism.

There were also too many mathematicians involved. They were too good at mathematising it and putting out all these wonderful new instruments that hardly anybody understood. The CDOs and all the derivatives in second and third order based on all the CDOs. I mean, can anybody make sense of it? I do not think that anybody really understood what was going on.

But it was beautiful mathematics and it generated the instrument whereby this balloon could be inflated on and on. The third is that what made it all possible in a technical sense was deregulation. Particularly, the repeal of Glass-Steagall, which I think should have been reimposed by the Obama administration, but will probably not happen.

So that is the technical reason why it became possible to do all the derivatives. But what I would argue is that what is really at stake here is a value shift. In the sense that if the "captains of industry" and the old type of commercial morality that Ken Arrow was looking for had remained in place, deregulation might not have led by necessity to this bonanza of absolute insanity that cost us, and is still costing us, untold trillions of dollars. So let me just suggest that Thatcher/Reagan/Friedman/Individual/Me-First ideology that became a public culture, filtered into the private norms systems not only on Wall Street, but also at Main Street – in a sense that made nobody think that this is ugly, immoral and is going to lead us down the sinkhole. Remember "greed is good"? Remember Wall Street the movie; and Boesky, who told the commencement class at Stanford University Business School once, "I feel that we can be greedy and feel good about ourselves." And if you feel that greed is good then there is really no moral limit to the CDOs and all this. I know that Phil does not agree with me on this issue, but I think that one is necessary and the other is sufficient for the crisis to really erupt.

Steve Pejovich: But if you really want to criticise CDOs for their composition, you should ask what is their function? Their function is to maximise shareholders' value. And then you should compare the rate of change in their composition, with the rate of change of stocks . If the increase in their composition is not much different from the improvement in the price of the stock, they are not overpaid.

Karl-Peter Schwarz: I have a very quick observation of, let us say, a methodological nature. The German historian Alexander Demandt once put up a list of the reasons which have been mentioned for the Fall of the Roman Empire. Do you know how many voices he had to list? I do not remember the exact number, but he quoted more than two hundred reasons for the fall of the Roman Empire. So why should it be so different with the fall of the Soviet Empire?

From the economic point of view the most convincing arguments were advanced in 1920 by Ludwig von Mises. He came to the conclusion, that the destruction of the price system would unavoidably lead to the collapse of the economy. This was a logical answer, a true answer. But Mises could not say when this collaps would occur, because there were many other elements which could accelerate or delay it. It is helpful to reread Carl Menger and his seminal text about the methodological questions of the social sciences; Menger distinguished between the apriori economic method and the historical method. Regarding the analysis of reality as a whole the economic method is not more than a *Hilfswissenschaft,* indispensable to understand what happens, but not sufficient to give us the complete picture.

Krassen Stanchev: I am not sure, Stefan, about what kind of deregulation before the 2008 crisis you refer to. In my view everything is about *re*-regulation, starting from the late forties to sixties and then Liechtenstein, and of course the reregulation of the exchange rate. So all this is not deregulation, but just the opposite.

John Moore: Phil – would you like to respond?

Philip Hanson: Yes, I am not going to try to do anything like respond to the whole wealth of points that have been made, and I would say to Stefan that I do not disagree with him, I just half agree with him. Just a couple of points and a footnote: the first point is about the way in which liberal economic theory seems to have shifted from being positive, to being also normative. We used to live in a world where there were a number of different national economic systems, which each consisted of bundles of different institutions that were quite different from those in other countries. And we used to have courses on comparative economic systems. Then increasingly the alternatives to Anglo-Saxon capitalism sort of fell away. Or have they? That is my question.

If you look at a lot of the rankings of economies in the world – the World Bank's Ease of Doing Business ranking is perhaps the best known one of all – it is saying in effect that we are all playing the same game, and we are just competing more or less efficiently at playing that game. I have to wonder whether that is strictly true, and whether we ought to think of there continuing to be some national economies which have some radically different sets of institutions. There is a book which I strongly recommend, and which I think is a very important book, by Ronald Dore – a specialist on Japan – called "Stock Market Capitalism: Welfare Capitalism: Japan and Germany versus the Anglo-Saxons," published in 2000. In it he says that it looks as though the Anglo-Saxon set of institutions will increasingly predominate, tending to become more important, and the economies of Germany and Japan are moving in that way themselves – subject to there being some major financial collapse in the Western world, which might produce a rethinking of it. Now I think that rethinking is part of what we are seeing going on – what Stefan is part of.

Second point about the failure of transition, or whether it has been a failure: what one means by a failure of transition. I just throw out the thought that transition was embarked upon circa 1990, in a group of basically European countries, of which the overall majority were already at middle-income development level. Quite recently Eichengreen and others have developed this notion of a "middle-income trap." If you embark on changing your economic system when you are in the middle-income range to begin with, it may not be too surprising that you hit difficulties later on. Because plenty of observations now suggest that middle-income countries which develop without changing their systems face an almost unavoidable slowdown – although there is some difference between oil exporters and non-oil exporters. So maybe we should be judging the success or otherwise of transition in the context of these being middle-income countries, which were trying to change when they were already approaching what was likely to be a barrier whatever their economic institutions were.

And the footnote is just about the collateralised debt obligations and all that – derivatives – is it possible that the work of Russian mathematicians in the back offices of Wall Street has something to do with this? A friend of mine was married to two of them in succession! Could it be a Russian plot?!

John Moore: Well, who knows?!

Steve Pejovich: When you talk about transition, or the success of transition, well all we know about these countries is that the system they had failed. I do not know to which the term "success of transition" presumes the objective that you are looking for. And I am not convinced this assumption they never told us they had.

Stefan Hedlund: The main opening of the sluice gates was the repeal of the Glass-Steagall Banking Act in 1933; and if they had not repealed that, it would not have been possible for the major financial operators to do what they did .

Tomasz Mickiewicz: I may be wrong, but as far as I remember the crisis started not in the US, but started at a state-owned bank in Paris – BNP Paribas – that was the first one that triggered the series of earthquakes. So why are we only focusing on the US? It was a state-owned French bank which was first in trouble.