The evolution of economic theory:
And some implications for financial risk management
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Introduction

This paper has its origins in a paper published in Issue 59 of the Real-World Economics Review (RWER) titled ‘Science and Support: The Struggle for Mastery in Economics’ (Spread, 2012). On the basis of that paper I was invited to speak at the Global Risk Conference of the Professional Risk Managers’ International Association (PRMIA).1 This paper is adapted from the talk given at the conference. The aim is to link the theory set out in the earlier paper (and in books) to financial risk management. An earlier presentation to hedge fund managers by Marc Groz (2004) titled ‘Risk and other Dark Matters’ provided an introduction to some concerns of financial risk managers.

The paper in Issue 59 of the RWER concerned a process of ‘intellectual support-bargaining’, whereby makers of theory seek the support of their associates for their ideas. It treats theory formation as akin to a tribal process in which the actual truth or substance of a theory is of lesser importance than its capacity to attract support. And the way to attract support is to develop theory that answers to interests. People with an interest in the maximum freedom of the individual will be inclined to support theories that indicate freedom of the individual is best for society. People with an interest in being looked after by society will be inclined to support theories that suggest we are all responsible for each other, and should all help each other to the maximum possible extent. All interests will endeavour to establish that their own theory is ‘natural’ or ‘scientific’ or ‘mathematically proven’, so as to give it the appearance of being in some way absolute, like the law of gravity. If a theory has the status of the law of gravity then it is non-negotiable. But social laws, of course, are not like the law of gravity. In social science, what matters is the support that accrues to a theory.

What matters also is success in institutionalising a theory. If systems of payments, promotions, careers, prestige and so on can be established, based on a particular theory, then people will find it advantageous to support the theory. Great institutions of learning have been established which become associated with particular theories or particular types of theory. They endure over time because their theorists initiate young people into the theory group, and because they can offer stable careers teaching and developing the theory. You do not need close acquaintance with human history to recognise that the weirdest theories have been supported and institutionalised to the great benefit of their advocates.

The paper in Issue 59 (Spread, 2012, pp. 47-8) suggests that neoclassical economics has been institutionalised on the basis of its mathematical content but with very weak science. Because it is institutionalised, it is difficult to replace it with more accurate theory. Many people find it difficult to reconcile the theory with their observation of the actual functioning of economies. The RWER forms a focus for efforts to develop an alternative. In recent years,

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1 Global Risk Conference, the Tenth Anniversary Conference, of the Professional Risk Managers International Association (PRMIA), held at the Marriott Marquis Hotel, New York, 14-16 May 2012.
particularly with the onset of the financial crisis in 2007, neoclassical economic theory has attracted ridicule (Spread, 2012, p. 47).

Intellectual support-bargaining is part of a more general process of political and social support-bargaining. The theory of support-bargaining is set out in Support-Bargaining: The Mechanics of Democracy Revealed (Spread, 2008). In spite of the title, the book is not entirely about politics; or rather, the theory of support-bargaining understands economic theory as part of the support-bargaining process and hence part of a political process. Politics advances interests through support-bargaining. Theory formation plays a large part in the assembly of support for political purposes. Few will disagree that neoclassical economic theory has had a major political role.

**Support-bargaining**

The idea of support-bargaining remains very little known, so it is appropriate to give some introductory account of it.

The psychological foundation of support-bargaining, as intimated above, is our sense of insecurity. Human life is lived in a state of insecurity, whether the threats come from invaders, employers or ill-health. The reaction to insecurity is to seek the support of others. Support is most eagerly sought and most readily given in the face of immediate violent threat, because that is when people feel most insecure. But support is important also in the most ordinary circumstances. If a shop assistant is rude to us, we share the offence with friends and receive their commiserations. In all circumstances, from the trivial to the most pressing, whenever we feel insecure, we seek the support of others. And given the pervasive insecurity, this means that we are perpetually seeking the support of others. To get support, we adjust our opinions and actions to conform with the prevailing view of what is right amongst those around us.

This leads to the formation of groups. People in similar situations tend to have similar interests and find it easy to get support from one another for the advance of those interests. Initially, the group forms to allay the sense of insecurity. But once the group is formed it can go further. The mutual support within the group builds a sense of confidence that the group is right in its claims. The group becomes convinced that the shortcomings it identifies in its situation should be remedied, if necessary at the expense of other groups. Groups formed through support-bargaining will seek to advance their interests, over and above the basic interest in reducing insecurity. A group that shows itself to be effective in advancing the interests of its members can expect to attract new members on its own terms.

A group will not only gain confidence through its formation. It will also develop an idea of its strength. Support provides security partly because it implies capacity for violence. In violent times, membership of a well-supported group implies protection against violence, and even the capacity to gain by violence. In Support-Bargaining (Spread, 2008, p. 386-7), it is suggested that in violent societies support is backed by violence in much the same way as gold has been used to back monetary systems. In modern political systems, support serves as a proxy for violence under a support convention. The backing of support by violence is much less apparent. The group with majority support is recognised as having the right to advance its interests. It is less trouble, less stressful, less painful, less damaging and less expensive than fighting for ascendancy. It has also proved to be much more constructive. This is the mechanics of what we call democracy. Our constitutions, elections, political parties
and pressure groups represent the formalisation of the informal support-bargaining that is our natural reaction to insecurity.

Intellectual insecurity is an aspect of our general sense of insecurity and results in the intellectual support-bargaining described in the paper ‘Science and Support’ (Spread, 2012). If you are concerned about the nature of the universe, the folly of humanity or the behaviour of people at work then the natural response is to approach your acquaintances to see what they think and see if it is possible to agree on an explanation. Agreement establishes theory and at the same time establishes a theory group. Such theory groups generate intellectual security.

Virtually every society has had supernatural beliefs that enabled it to explain the rising and setting of the sun, the nature of the stars, the behaviour of humans and the appropriate reactions to the various phenomena. Very commonly, the phenomena are personified, so that it becomes possible to deal with them in a person to person manner. Attention is focused not so much on the obscurities of the universe or human nature, but on the idiosyncrasies of beings that are understood to control these phenomena. For Greeks and Romans the gods and goddesses provided a continuing soap opera of dysfunctional family life. Everyone could recognise their problems and support their hero or heroine. Everyone could ask for the support of their favourite god or goddess. The gods and goddesses were drawn into human support-bargaining through personification. For most people, now and in the past, intellectual security has depended heavily on this sort of understanding.

**Money-bargaining**

Besides the gods and goddesses, money is perhaps a lesser creation of support-bargaining. But as long as everyone in a society supports the idea that a particular token has value in their community, then it will be possible to exchange the token for goods and services in that society. It exists and has a function in much the same communal way as gods and goddesses can exist and have functions. Gods and goddesses have been given physical expression as popular subjects for painting and sculpture. Dollars, Euros, Rupees and Roubles all have physical manifestations and have value in their societies because the people of those societies choose to recognise their value and formalise that value in their laws. Money functions as a bargaining counter and is central to the functioning of a money-bargaining system, in contrast to its role as incidental numeraire in the neoclassical model.

Money is thus a creation of support-bargaining. Its function as a bargaining counter gives it a further direct connection with support-bargaining. Where did we learn to bargain over goods and services? What tells us that when something is in short supply, we are going to have to pay more for it? What tells us that a monopolist has a strong bargaining position? The answer seems to be that we know these things because we all have experience of support-bargaining from our earliest times. We know that to get the support of the group we have to conform to the opinions and behaviour of the group. We know that if there is just one group from which we can reasonably expect to receive support, we have to accommodate the interests of that group. We have to concede more in opinion and behaviour for the support that will allay our sense of insecurity. But if there are many groups from which we can potentially gain support, as in a modern pluralist society, then we can afford to exercise our own individual preferences more freely, and still expect to get the support we need. The same dynamic applies in bargaining with money. Prices move in money-bargaining in much the same way as the terms of support-bargaining move between individuals and groups. We can engage in money-
bargaining because we unconsciously absorb the experiences of support-bargaining in our social life. It is not the rational choice of neoclassical theory, but the recognition of bargaining position that has been essential to human survival.

The identification of social theory with the intellectual security of the theory groups that create it makes it immediately apparent why we cannot do without theory. However bizarre the theory may be, we need the sense of security that is provided by common support for a theory. If everyone says the world is made of crispbread, then everyone can rest assured that they know what the world is made of. That is why also there is a tendency, perhaps less apparent now than in the past, to eliminate those who disagree, who may deny that the world is made of crispbread. Such dissenters erode the security of the group. Theory groups seem tribal because, like tribes protecting their territory, they have the sense that their security depends on their theory, and defence of their theory depends on their cohesion in the face of enemies that would displace them. Theorists claim the pursuit of truth, but the psychological imperative is the retention of support for their group, involving rejection of ideas that might divert support to a rival group.

The dependence on theory groups for security explains also why established theory can only be effectively displaced through the provision of alternative theory. Without theory, there is no theory group, and no security. The security of one theory will not be abandoned until another theory, offering comparable intellectual security, is available. Many neoclassical scholars, perhaps most neoclassical scholars, freely acknowledge the weaknesses of the neoclassical model. But before relinquishing the theory, they demand an alternative. The idea of support-bargaining and money-bargaining offers an alternative theory that may in the course of time unite the scholarly tribes. It is an important feature of support-bargaining that it offers an understanding of the theory-making process itself. Many intellectual sub-tribes can function under intellectual support-bargaining. It provides a 'theory of theories' in which different theories held by different theory groups may compete and compare in a process of intellectual support-bargaining. It does, however, make clear that there can be no absolute theory of society. Theories function as theories only so long as the support of a theory group can be maintained.

**Evolution of theory**

This theory of theory making means that theories will evolve over time in accordance with changing situations, changing interests and changes in group ascendancy. One characteristic of money-bargaining is that it gives scope for individuals to become wealthy, and consequently influential, independently of the support-bargaining process. Ascendant political groups have recognised this tendency, threatening to their ascendancy, and have sought to limit or control the emergence of strong money-bargaining agencies. In the sixteenth century in England the making of significant sums of money was looked on with suspicion by the crown. Anyone getting rich could potentially organise and finance rebellion. Companies of any size operated under crown charters, which meant that the crown could keep an eye on them and potentially share the proceeds of their success. Today, the Kremlin keeps a close eye on the behaviour of Russia's leading businessmen and business organisations. In many developing countries businessmen are encouraged and in some cases required to maintain links with a ruling political party.

The evolution of money-bargaining and economic theory has followed upon and stimulated the idea of individual freedom in western society. Historians recognise the seventeenth
century in England as a crucial period in the emergence of the individual freedoms of modern society. It is part of the common cultural evolutionary heritage of societies on both sides of the Atlantic, and of many other regions. Its turmoil culminated in the ‘Glorious Revolution’ of 1688. The Revolution restricted the power of the monarch, providing instead for a large measure of parliamentary control, and in particular increased control over government finance. Relieved of the suppression of autocrats, money-bargaining could expand. The individual interest could also be expressed and advanced through theory making. In the late eighteenth century Adam Smith produced his great testimonial to the material benefits of individual freedom from the constraints of government. Theories of individual freedom were enhanced and enshrined in the Constitution of the United States.

In the nineteenth century the business interests emerging in an era of industrial advance came to see the threat to individual freedom, and the freedom to engage in business, as coming not so much from any immediately ascendant group but from the prospect of greater engagement of the great mass of the population in government. The grievances of people deriving from the dislocations of industrial advance were evident. Their potential for government, by revolution or by constitutional reform, was also apparent. Karl Marx provided theory tailored to assemble support for the group interest. Theorists on the right responded with the formulation of neoclassical economic theory, presenting in severely rational terms the advantages of leaving business activities to individuals without interference from governments.

Neoclassical theory has formed ever since a major theoretical bulwark against the theories supportive of the group interest. Friedrich Hayek and Milton Friedman were called to the support of Margaret Thatcher when she was Prime Minister in Britain in the 1980s. The fact that these theories were well-supported in the academic community meant that it would be easier to assemble support for measures based on them in the political sphere. The contributions of theory makers to the ascendancy of political groups do not go unrecognised. Frederic Lee, in a study of the research assessment process in British universities (2007, p. 322) notes that the process of evaluating performance of British universities was developed in such a way as to reinforce the dominance of “…the pro-market ideology adopted by the Thatcher, Major and Blair administrations since 1980…”. The paper shows how an ascendant theory group can use its ascendancy to ensure that official evaluations generate support for its continued ascendancy.

Neoclassical theory has evolved substantially since its initial development in the later nineteenth century. It has sought to keep abreast of emerging concerns through such innovatory additions to the basic model as ‘asymmetric information’, ‘rational expectations’, ‘economic rent’ and ‘market failure’. Perhaps its greatest innovation was that introduced by John Maynard Keynes in reaction to the manifest inadequacy of the existing theory to explain the severe economic depression of the 1930s. A functioning neoclassical economic system could not countenance any unemployed resources, so the situation in the 1930s presented a fundamental challenge to the theory. Keynes modified the theory in a way that gained the major objective of re-establishing neoclassical theory as a supportable understanding of the functioning of an economy, whilst sacrificing only so much of the theory as was absolutely necessary to gain this major prize. It was accepted that the financial sector did not follow the simple market processes that the model defined.

There are, nevertheless, certain rigidities in neoclassical theory that prevent its rapid or easy evolution. It is a mathematical construction, and mathematics is understood as timeless. By
analogy with physics, if something is mathematically demonstrated, then it takes on the status of the law of gravity. It cannot be questioned, far less changed. Neoclassical theorists evaded the obvious objection to this understanding of the status of mathematics by establishing that the assumptions underlying neoclassical theory are of no account. Milton Friedman’s (1953) famous methodological essay claimed that unrealistic assumptions were of no concern. What proved or disproved the validity of a theory was its capacity to predict. And it was claimed that neoclassical theory could predict outcomes, and could therefore be regarded as valid. The paper has been highly influential. Daniel Hausman (2008), in an article in the Stanford Encyclopaedia on economic methodology, comments that, “This essay has had an enormous influence, far more than any other work on methodology”.

The other factor which makes neoclassical theory slow to evolve is its heavy institutionalisation. Neoclassical theory has become, around the world, the mainstay of university instruction in economics. Frederic Lee’s (2007) paper makes it clear that in many British universities ‘economic theory’ is still ‘neoclassical economic theory.’ Important institutional career interests have become bound up with the maintenance of neoclassical theory.

The previous big crisis for neoclassical theory emerged in the face of extensive unemployment in the 1930s and, as suggested above, was resolved by Keynes. Many would say there is now another big crisis for neoclassical theory in the general failure of neoclassical economists to predict the financial crisis of the last five years. If neoclassical theory is so good at predicting, how come it did not save us from the near-meltdown of the recent period?

Economic theory, risk management and the unexplained residual

This, of course, is where economic theory meets financial risk management. After the failure of neoclassical theory, what can the idea of support-bargaining and money-bargaining tell us about the financial failures of the recent past?

The relationship between support-bargaining and risk management is very close. Psychologically, it is hard to distinguish between insecurity and uncertainty. The distinction is more semantic – uncertainty is more a matter of intellect and understanding. Uncertainty is intellectual insecurity. So straight away, risk management is going to involve support-bargaining. The sense of insecurity will cause everyone engaged in risk management to look to their associates for resolution of the uncertainties. Groups will be formed within which uncertainties are allayed.

Douglass North notes in Understanding the Process of Economic Change (2005, p. 14), that economists have displayed a good deal of ambiguity over uncertainty. For neoclassical economists, the default situation is certainty. All relevant information is known in the neoclassical model. So to protect the model, uncertainty has to be an unusual condition. North notes that uncertainty is not an unusual condition, but rather the normal situation. He (2005, pp. 23-4) notes that, “The tendency of economists to carry over the rationality assumption in undiluted form to more complex issues involving uncertainty has been a roadblock to improving our understanding of the human landscape”. In the context of financial risk management, where uncertainty is of such prominent importance, the retention of an undiluted concept of rationality clearly constitutes major misconception.
North argues that in response to uncertainty, in order to reduce uncertainty, humans construct rules. The New Institutionalist case is that these rules constitute the institutions that structure the human environment to make it more predictable, and hence more tolerable. (We move here from the idea of ‘institutions’ as permanent, or at least durable, public organisations, as referred to above, to the idea of ‘institutions’ as systems of rules.) The question then arises, as North puts it (2005, p. 15), “…who makes the rules and for whom and what are their objectives… one of the major puzzles to be explained is how and under what conditions, humans create the conditions that make for markets with low costs of transacting and increasing material well-being”.

Support-bargaining provides the answers. The rules, the institutions, are the creations of support-bargaining. It has already been seen that support-bargaining created money, which is regarded by institutionalists as an institution. It has been seen also that money-bargaining derives from support-bargaining. All the associated rules and regulations that govern money-bargaining may also be understood as outcomes of support-bargaining. Regulations regarding opening hours of shops, conditions of employment, fulfilment of contractual agreements, liability for damage, quality of goods, representation of goods, provision of information about products, procedures for the establishment of businesses, constraints on monopoly, and so on, are all outcomes of support-bargaining.

Support-bargaining in fact goes much farther than explaining the institutions of Douglass North. North (2005, p. 14) sees institutions as rational responses to uncertainty. The rules are constructed so as to reduce the flexibility of choice in the face of uncertainty. But he remarks (pp. 15-16), “Throughout human history there has always been a large residual that defied rational explanation – a residual to be explained partly by non-rational explanations embodied in witchcraft, magic, religions; partly by more prosaic non-rational behaviour characterized by dogmas, prejudices, ‘half-baked’ theories”. All these too are outcomes of support-bargaining. In the face of uncertainty, humans create theories that explain the phenomena they observe. The important point about such theories is not that they describe in a scientific sense the observed phenomena, but that they generate communal support. Communal support reduces uncertainty.

So it is with risk management. In the face of uncertainty we generate theories through support-bargaining. Financial risk managers have followed neoclassical economists in relying on mathematical modelling to reduce and even eliminate risk. As noted above, on the analogy with physics, mathematics defines what is and what is not true, beyond uncertainty. Risk management has depended heavily on mathematical formulations that purport to cover the probabilities of this or that occurrence. The community has agreed that mathematics will resolve its uncertainties.

Marc Groz’ (2004) presentation on ‘Risk and Other Dark Matters’ makes some valuable observations on this faith in mathematical formulations. The second and third paragraphs (p. 1, original emphasis) run as follows:

My title for this talk is ‘Risk and Other Dark Matters.’ To me, risk is too dark a concept to be illuminated by light metaphors alone. I think of it as something that hides in the dark, like the so-called dark matter of the universe, which along with an even more mysterious dark energy, is said to account for more than 90% of the mass of the universe. What we see is a sliver of what is there. So with many forms of risk. Yet in
each case, we can infer existence of hidden complexity from the behaviour of what is visible.

When I think about the many guises assumed by risk in our business, I have to admit that neither transparency nor translucency spring to mind. Murk is more like it. Risk is a complex, murky thing, hard to see, harder still to grasp. Risk management is a phrase hovering uncomfortably close to hubris. Sort of like the phrase ‘portfolio optimization’ which seems far too optimistic a goal for a branch of the dismal science.

Like Douglass North, Groz finds a large unexplained residual, a hidden complexity, in the approaches adopted to risk management. He implies also the existence of a large unexplained residual in economic theory. 90% of the mass of the universe escapes us, and by implication a similar proportion of the process of risk management is lost to our view. My suggestion is that the residual is the process of support-bargaining. It constitutes the hidden process of risk management. To manage risk, you talk with your colleagues and determine what can be agreed among you as the proper way to manage risk. In earlier periods risk was managed through attention to the entrails of goats or the alignment of the planets. Today it has been agreed that in large measure the way to manage risk is to create mathematical models linking what are understood to be the critical factors. Underlying both techniques is the assurance gained by the support of those involved for the techniques adopted.

Groz made his presentation in 2004, well before the mathematics came truly unstuck in the recent crisis. Without that event, it would be more difficult to criticise the mathematical approach. Prior to the crisis, the financial sector seemed confident that the mathematical formulations had taken much of the risk out of risk management. Groz (2004) comments that “The fantasy of the riskless strategy dies hard”. If the strategies continuously pay off, it becomes more and more difficult to recognise the possibility that their foundations might be fantastical.

**Security in the herd**

The security inherent in support means that humans are inclined to congregate in groups. In colloquial terms, it means humans have a ‘herd instinct’. The term is commonly used to describe the destabilising effects of sudden movements in human opinion and commitment, as when a herd stampedes. Or it may describe the adhesion of people to groups and ideas that seem to have little attraction, even little relevance to their interests, other than being a source of reassurance. In the financial world, the ‘herd instinct’ is well attested. Stock prices move not just by reference to the expectations of financial returns from the stock based on trading prospects, but from the recognition that many people expect the stock to move up or down. So stock prices can climb to great heights because people bid them up on the expectation that others will bid them higher. Then a recognised herd leader begins to sell; or some event, or some release of information, makes it clear that the trading prospects of companies do not justify their stock valuations; and expectations are revised. The stock price heads in the other direction as people sell in anticipation that the price will fall further as others sell.

The changes are dictated by the pursuit of support. There is support and security in doing what others do, in following group opinion. People express their support for group opinion through purchase of the stock when the group thinks it will rise, and through sale of the stock when the group thinks it will fall. People have confidence that they are doing the right thing
when they do what everyone else is doing. An individual is generally secure from blame if following the group leads to trouble, because the group will sit in judgement, and is likely to exonerate itself and those who followed it. Those who act in accordance with group opinion can expect the continued support of the group.

If financial risk is to be successfully managed, it is necessary to incorporate in the process an account of the effects of support-bargaining on stock prices. People feel more secure when they move with a group, but the feeling of security arises from the sense of support from the group, rather than from any necessary capacity of the group to assess true values. There are, of course, real difficulties in modelling the influence of support-bargaining in quantitative terms; which means there are real difficulties in modelling the behaviour of stock markets in quantitative terms. More than that, as suggested earlier, the elevation of quantitative modelling itself to a decisive role is an outcome of support-bargaining and is itself likely to involve the instinct for security within the group.

Valuation and Support

The herd effect, or the high intensity of support-bargaining, involved with the present crisis was particularly marked because many of the securities whose values became inflated and then collapsed were particularly obscure with regard to their real economic value. They were packages of different obligations, with debts relating to sub-prime mortgages somewhere in the mix, which in the end proved particularly toxic. Very few people can possibly have worked out the real trading value of these securities. In the face of such uncertainty over their value, people inevitably resort to support-bargaining. They depend on others to confirm that they are fairly priced. They believe with everyone else that mathematical techniques are appropriate and have been properly used in pricing the securities on offer. They believe the ratings given by the organisations established to evaluate the status of debt. It is, of course, potentially advantageous to some to be selling securities whose value depends to a high degree on the support accorded them, with no searching questions asked about their underlying value deriving from the real economy. Securities are designed to attract support in the support-bargaining of the financial community, and by attracting support, also attract buyers. Tony Lawson published a paper in the Cambridge Journal of Economics titled ‘The current economic crisis: its nature and the course of academic economics (2009)’. In it (p. 772), he remarks of collateralised debt obligations that:

They were perceived as relatively safe because, as noted, the rating agencies gave them a high rating. But in truth, the products so bundled came from hundreds of thousands of unidentifiable sources, and their credit worthiness and cash flow possibilities could not be determined. Being more or less completely opaque to those who bought them, and seemingly often intentionally so, they were, at best, highly risky and in fact extremely precarious.

The financial community generated support for these securities and took out the uncertainty, or insecurity, that should properly have surrounded them. It tried to realise its fantasy of risk-free investment by using support-bargaining to eliminate uncertainty. The matter came to a head in late 2007 when one of the leading banks, BNP Paribas, recognised that it could not reliably value some of its funds and suspended trading in those funds. The whole herd then reappraised its position, tried to offload the newly questionable securities, and found itself caught in a financial crisis.
The shock was no doubt the greater because the herd had been moving very confidently in the months preceding the financial crisis. Regulators and investors alike were caught up with the idea that the booming markets were not bubbles, because mathematical analysts had resolved the problems of pricing stock. This time, things were different. Daniel Hausman (2008), in the paper mentioned above, written before the crisis, and otherwise deeply critical of economic methodology, thought himself obliged to concede that, “…contemporary economists are much better at pricing stock options than economists were even a generation ago”. As Groz (2004, p. 1) puts it, risk management was hovering close to hubris.

Lawson’s (2009) account of the problems of neoclassical theory focusses on the use of mathematical deductive modelling. He argues (p. 766) that the assumptions commonly required as the foundation for such deductive modelling are far too restrictive to make the conclusions of such analysis relevant for any practical purposes. In academia, such analysis is fundamental (p. 775) “…for research recognition, academic appointments, promotions and everything else” – the effects of institutionalisation of theory are apparent. But outside the confines of academia it has little relevance. It does not give a plausible account of how economic systems actually function. It was seen earlier that, as far as neoclassical economists are concerned, the problem of unrealistic assumptions was side-lined by Milton Friedman’s methodological essay emphasising the importance of prediction and the irrelevance of assumptions.

The influence of neoclassical commitment to modelling and Friedman’s methodological principles are apparent in the mathematics of financial risk assessment. The Capital Asset Pricing Model developed by William Sharpe (1964) and others seems to depend on the irrelevance of assumptions. Lawson (2009, p. 767) records Sharpe’s admission that the inputs required to generate his conclusion are:

…highly restrictive and undoubtedly unrealistic assumptions. However, since the proper test of a theory is not the realism of its assumptions, but the acceptability of its implications, and since these assumptions imply equilibrium conditions which form a major part of classical financial doctrine, it is far from clear that the formulation should be rejected. (Sharpe, 1964, p. 434)

In other words, since the proposed model confirms established theory, the basis in unrealistic assumptions constitutes no reason for rejection of the model. Sharpe loosens even Friedman’s criterion for the validity of a theory – the accuracy of its predictions – by adopting ‘the acceptability of its implications’. It appears that the Capital Asset Pricing Model was adopted within the financial community to dispel the uncertainty surrounding the pricing of capital assets, but it rests not just on uncertain assumptions, but on assumptions that are known to be false. It is a good example of the way group support can sustain ideas that are convenient to the group regardless of the foundation of such ideas. It is a good illustration also of the way in which conclusions of mathematical analysis, if they are convenient, are taken up while the dubious foundations of the analysis are forgotten. More broadly, it illustrates the process of theory formation through support-bargaining that has created and sustained the ascendancy of neoclassical economic theory. In this case, the toxin of neoclassical methodology has been allowed to seep into financial risk management.

Lawson (2009, p. 760, p. 775) argues that mathematical deductive modelling should not be abandoned, but that its importance in economics faculties should be diminished, leaving scope for consideration of broader approaches. Scholars should seek an understanding of the
social order as a basis for understanding of economic and financial processes. He remarks (p. 765) that, “The network of accepted social positions and associated rights and obligations coordinates social life”. He is clearly close to Douglass North’s institutional concept of society and North’s ‘unexplained residuals’. He is concerned with the same ‘hidden complexity’, or ‘dark matter’, identified by Groz (2004, p. 1) in financial risk management. He reflects also the strictures made above on the possibilities of effectively modelling financial risk.

The obscurities arise because there is no understanding of support-bargaining. Because uncertainty and risk are so prominent in financial markets, it is to be expected that there will be a particularly high intensity of support-bargaining, because support-bargaining is the reaction of humans to uncertainty and insecurity. The way those engaged in financial markets group together spatially, in ‘the square mile’ and on Wall Street, is an indicator of the importance of support-bargaining in its most personalised forms. The development of electronic communications has facilitated support-bargaining in relation to financial markets on a global scale in less personalised forms. Support-bargaining is a natural human reaction to uncertainty and insecurity, so it is unlikely to be eliminated entirely from the management of financial uncertainties. But an understanding of its dynamics applied in the formulation of policies and practices relating to the management of financial risk will potentially reduce its adverse effects.

References


