

# Processes vs. mechanisms and two kinds of rationality

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## Introduction

The contribution of standard mainstream economics to the development of the global financial crisis that began in 2007 has been analyzed in several recent papers. Some authors have denied that mainstream economic theory has had any responsibility in its occurrence and have argued that it could not have been predicted or anticipated. Colander (2010) argued that the actual economic system is so complex that available current models (“DSGE models”) are not sophisticated enough to detect the imminence of such a crisis. In fact, according to him, the situation is even worse because it would not have been possible to foresee the crisis even if the profession had been provided with more sophisticated mathematical models. The problem lies then not in standard economic theory *per se* but in the nature of economic phenomena.

In opposition to this interpretation, some authors have pointed out that the prevailing view of financial systems has much of the responsibility for the occurrence of the crisis. Haring (2013), to quote a recent testimony, argues that conventional textbooks in the field offer a distorted treatment of the nature of money and the process of its creation, and hide the close relationship between central banks and private banks. In particular, the current literature does not mention the fact that most of the money created comes from private commercial banks<sup>1</sup>. Even more troubling is the hypothesis of efficient markets, which in conjunction with rational expectations theory makes impossible (by hypothesis) the occurrence of crises, inducing a wrong analysis of the role of liquidity and ignoring the conditions that can lead to a crisis. Standard economics were not well fitted to appraise the health of the global economy.

“Why did the majority of economists fail to foresee the Global Financial Crash of 2008?” We can now answer this question quite simply as follows. The majority of economists were members of the Neoclassical School. They therefore accepted the core of the neoclassical paradigm, namely equilibrium theory.

According to equilibrium theory, a market governed by free competition moves into a Pareto-optimal equilibrium. Now the financial markets throughout the world had in the decades before 2008 been deregulated and so made to approximate to a freely competitive market. Hence neoclassical economists deduced from their economic paradigm that these financial markets would move towards equilibrium rather than crashing in a catastrophic fashion. (Gillies, 2012, p. 32)

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<sup>1</sup> Such omissions pose a problem, because “this rhetoric frames the minds of central bankers, other policy makers, academics and - through economic journalists educated with the same textbooks - the general public, in a very unfortunate way. This prevents them from understanding the current financial crisis and from drawing the right policy conclusions from it” (Häring, 2013, p. 3).

The usual “naturalistic” perspective of current mainstream philosophy of economics, with its concern for “recovering” the rationality of mainstream modeling practice (in order to illuminate the problem each model was attempting to solve) seems to be at best irrelevant in such circumstances, and, at worst, a part of the network of concealment. What is required is a different way of approaching the economy and its theoretical representations. We need to rethink the economy. The aim of the present paper is to contribute to this task. It joins the wave of growing interest – shown in numerous recent articles – in building an approach able to pay more attention to real economies and the actual economic practice. A non-mainstream epistemological and philosophical vision about how to look at the economic problems is now under construction. The proposals in this regard are still partial and piecemeal, but exhibit important common grounds around issues of common interest. This program contrasts with the exaggerated emphasis that the mainstream philosophy of economics has placed on the analysis of arbitrary economic models, and contests the still ungrounded claim that unrealistic “parallel” worlds have nonetheless cognitive relevance.

Rethinking economics is an eminently philosophical task. It is not the same as (or not reduced to) making economic theory, something that has to be done by the economists themselves. It is rather to think about both economic theory and the real economies. Rethinking real economies includes the examination of their particularity as a process and their ontological characteristics; rethinking economic theory includes assessing the epistemic and ontological assumptions of current theoretical practice (Fullbrook, 2013, 2014). Both tasks are urgent and necessary, given that the mainstream philosophy of economics pays no attention to real economies and is inclined to justify (a-critically) any sort of conventional theoretical practice. Rethinking economics must be sensitive to the growing awareness that economics as a discipline should focus on solving important problems, which immediately affect the lives of most people (poverty, unemployment, growth, inflation, to mention just those which require more urgent attention), rather than finding sophisticated solutions to theoretical puzzles which only restrictive academic circles find worth of interest. I encourage people to ask Boland’s question any time a suspicious model is exposed (Boland, 2005)<sup>2</sup>.

In a recent work (Ivarola et al, 2013), some central ideas the authors believe should be part of a more adequate philosophy of economics have been outlined. It was held that one of the fundamental aspects of the new vision is to reject the idea that the discovery of mechanisms is or should be the central goal of economic theory. It is better to consider economics as providing inputs in order to think (and command) processes. In this paper, four main aspects that have not been addressed – or are not properly highlighted – in that work are discussed. They are the following.

1) Wishful thinking. Emphasizing processes, particularly their openness, could be interpreted as if some form of wishful thinking is promoted. This is not the view I sustain. I rather defend a

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<sup>2</sup> “I am, as you can imagine, a methodological terror in my department, and have been for twenty years. I am a terror not because I come in and pontificate about methodology. I never talk to my colleagues about Popper or anything – they couldn’t care less, and I understand that. I understand my audience. All I do is, when they give a seminar on whatever fancy thing they are doing at the time, I will ask them, before they get started, why did they bother to do this paper? Now this is a terrifying question for people. First of all, they spent \$50,000 or \$100,000 on research, and they know they’ve got garbage, and they don’t want you to let anybody know *that* because they are responsible for the research, and so on. You know, the worst thing you can have is somebody asking the question of why you are doing this” (Boland, 2005, p. 157)

limited social constructivism, where rigidities (constraints) make a difference and not all one imagines or wants is an attainable target.

2) Openness and stability. That processes are “open”, in our sense, implies nothing about their stability. Given that the recent financial crisis has put on the agenda the discussion of complex systems, it is important to examine some of the conditions that led to instability in the global economy and the difference in nature between this feature and the open character of economic processes. The ability to integrate both views in the same analysis is also examined.

3) The existence of mechanisms. Recognizing economic processes does not eliminate the possibility that in some circumstances they may be working together with more rigid sequences of events, which may be assimilated to mechanisms (in one of the senses considered by the current literature about this issue). The nature of these more stable sequences as well as the particular conditions that allow their manifestation must be investigated and understood.

4) Rationality. It is difficult to accommodate the traditional view of rationality within a framework in which the presence of uncertainty and the openness of economic processes is admitted. However, this can be done if we leave off the deliberative and ex-ante notion of rationality, one which precedes decision making, and develop a concept of ex-post rationality, which consists in validating the decisions already adopted.

Properly understood, these points are compatible with (and complementary to) the processual view of economics that I wish to defend. In what follows I will examine the contribution of some recent works to approach these issues and the way in which these ideas can (or cannot) be articulated with my perspective.

### **1. Management of processes does not imply wishful thinking (it is not true that anything works)**

White (2013) discusses the anti-crisis policies adopted by the United States and central European countries during 2008-2011. He shows that what he calls “ultra easy monetary policy” implemented by the central banks of these countries during that period was doomed to fail. To sustain this position White appeals to the idea that our current actions can have inevitable consequences in the long term, which are unexpected and possibly unwanted. Such policies, according to White, are not a “free lunch”: they provide some immediate benefits but impose very high costs in the future. His analysis has interesting implications for the distinction between economic processes and mechanisms, a distinction that I want to defend. White bases his analysis on a classical formulation of the thesis:

“No very deep knowledge of economics is usually needed for grasping the immediate effects of a measure; but the task of economics is to foretell the remoter effects, and so to allow us to avoid such acts as attempts to remedy a present ill by sowing the seeds of a much greater ill for the future” (Ludwig von Mises, *The Theory of Money and Credit*).

Other authors have also supported this perspective (Hayek and Popper among them). Although this argument has been offered within the framework of a liberal and philosophically conventional view of the economy, many economists (probably most), even within the heterodox field, agree with it. This thesis, if it has any sense, has to be interpreted literally. It says that in some cases when a measure X of economic policy is adopted with the purpose of solving urgent problems, it may lead, in the long term, to consequences Y that can worsen the very issues that demand immediate attention. In such cases doing X inexorably leads to Y. And this result will occur regardless of subsequent intentions and actions of the authorities that have produced X. In addition, it is claimed that the unwelcomed consequences are only unexpected to the untrained observer. As the quote from Mises suggests, a sort of cognitive asymmetry between experts and laymen is assumed. Furthermore, it is argued that the task of economics as a science, is (or should be) the ex-ante identification of the causal link between the initial policy measure and its remote consequences, a nexus that lies beyond the reach of common citizens. To the extent that the causal link is known, the consequences of the action may be anticipated. This has been part of the battery of arguments used against any interventionist project on the market. White's contribution seems to be on the same track. His paper investigates whether, despite its proven failure it would have been possible to implement policies of easy credit avoiding the already known consequences. His findings seem to support an anti-interventionist vision.

“Stimulative monetary policies are commonly referred to as ‘Keynesian’. However, it is important to note that Keynes himself was not convinced of the effectiveness of easy money in restoring real growth in the face of a Deep Slump. This is one of the principal insights of the General Theory. In the current circumstances, two questions must be addressed. First, will ultra easy monetary conditions be effectively transmitted to the real economy? Second, assuming the answer to the first question is yes, will private sector spending respond in such a way as to stimulate the real economy and reduce unemployment? It is suggested in this paper that the answer to both questions is no” (White, 2013, p. 23).

However, White does not oppose all monetary policy *per se*, and he is not trying to defend a general argument against interventionism. Rather, he examines the particularly extreme form that this policy adopted during the recent crisis. The text suggests that once an extreme decision as the one which is the subject of analysis has been taken (interest rates close to 0 and very easy access to credit allocation), certain undesirable effects will ensue. It sounds reasonable: extreme measures may limit to such extent the margin of maneuver of the authorities, that it will be very difficult or impossible to counteract or rectify their effects later. But the article does not rule out that adopting more cautious policies, potential adverse effects could have been tempered or eliminated by subsequent measures. It is then possible to intervene more intelligently, and it is this idea that the author seems to convey in his final conclusion.

“Looking forward to when this crisis is over, the principal lesson for central banks would seem to be that they should lean more aggressively against credit driven upswings, and be more prepared to tolerate the subsequent downswings. This could help avoid future crises of the current sort. Of course the current crisis is not yet over, and the principal lesson to be drawn from this paper concerns governments rather more than central banks. What central banks have done is to buy time to allow governments to follow the policies that are more likely to

lead to a resumption of ‘strong, sustainable and balanced’ global growth. If governments do not use this time wisely, then the ongoing economic and financial crisis can only worsen as the unintended consequences of current monetary policies increasingly materialize” (White, 2013, p. 50).

It is worth noting also that White’s results against monetary policies are obtained by examining the operations of the market in the traditional manner, considering only the action of purely economic factors. Limiting the analysis to the domain of economic variables, and given the extreme nature of the measures, his paper shows that no sustained growth could be achieved in these conditions. But it should be noted that the alleged inevitability of the crisis is achieved by leaving out consideration of the possible introduction of regulations and substantial institutional changes able to force agents and other economic actors to adopt different behaviors. The introduction of regulations and institutions opens new scenarios. One of the subsequent measures that could be adopted is the enforced condition that the money provided to the private sector be used to generate productive employment activities, preventing its speculative use<sup>3</sup>. White does not examine the effect of a regulation of this kind. He does not, because he seems to be analyzing the operating market system in a “pure” form. There is little doubt that, in the absence of regulations, the market is unable to prevent speculative bubbles and subsequent crises.

In my opinion, it would be more appropriate to argue that his article shows the inadequacy of wishful thinking, not interventionism. White opposes wishful thinking with the epistemological tools he finds at hand (the theory of unintended consequences, which presupposes the existence of transmission mechanisms). This commitment is effective for his purpose, but is too strong, and unnecessary. To oppose that view, it is enough to show that there are concrete rigidities (physical and institutional restrictions) that cannot be dismissed. As pointed out, the extreme measures he considers generate constraints that can disable any further managerial effort to redirect the economy in order to achieve the objectives initially pursued. Our perspective rejects wishful thinking, and at the same time is not committed to the (ubiquitous) existence of transmission mechanisms, known *ex-ante* by economic science and ignored by laymen and “men of practical knowledge”<sup>4</sup>. A very needed task of the “new paradigm” for rethinking the economy should develop a stronger criticism of the alleged inevitability of certain outcomes and a more sustained effort in showing the conditions under which such “inevitabilities” are obtained.

Another interesting aspect of White’s analysis is that he assigned to the thesis of the unintended consequences of our current decisions a meaning that differs from the traditional sense: instead of pointing out the supremacy of the “experts” (in this case, users of mainstream models) compared with non-trained people, he argues that those models have NOT been effective in showing the unintended consequences of the extreme liquidity policy implemented before, during and after the crisis. White turns against mainstream economic theory a key part of mainstream epistemology.

“The unexpected beginning of the financial and economic crisis, and its unexpected resistance to policy measures taken to date, leads to a simple conclusion. The variety of economic models used by modern academics and

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<sup>3</sup> For a discussion of the distinction between production and speculation, see Reinert, 2013.

<sup>4</sup> See Ivarola et al, (2013).

by policymakers give few insights as to how the economy really works. If we accept this ignorance as an undesirable reality, then it would also seem hard to deny the possibility that the policy actions taken in recent years might also have unintended consequences” (White, 2013, p. 30).

Here’s an interesting argumentative twist. White believes that standard models do not help us understand how the economy works and those who were surprised by the upcoming of unexpected consequences this time were the users and builders of these models. Other authors have stressed the same point. Not surprisingly, if policies are implemented on a wrong basis they will probably show unintended consequences. We are at the antipodes of Mises’ claim: while “best” available models failed to anticipate the long run, many “outsiders” have accurately perceived far-reaching consequences (Keen, 2013). Our interpretation is that “outsiders” have been more effective in this task because they have paid more attention to real economies and conceived them more as social processes than as economic mechanisms, and this conceptual change allowed them to focus on factors that were omitted in the conventional picture.

One point of disagreement between my vision and White’s point of view concerns the nature of the unexpected economic consequences. In his opinion, they come from epistemological (or gnoseological) reasons. I consider them differently, although both views seem to be complementary with one another. Though we do not know what will happen in the long run, this ignorance is not a pure epistemological phenomenon but has ontological foundations. It is the open nature of the process which often makes the resulting end unexpected. And it is not caused by bad models. There is no hope that better models may prevent us from being surprised by the future outcomes of our present policies. Radical uncertainty prevails.

Although given uncertainty there is no scientific way to assign relative probabilities to different possible outcomes, agents and actors can know for sure what outcomes among the feasible ones would be most beneficial for them in case they occur. They are experts in their own interests. Therefore all relevant actors seek to manage the results! In fact, some big players make extensive use of a rhetorical device, insisting that they know what cannot be known: saying again and again that such and such policies will/will not yield some desired/undesired results; but their own haste to assert such a thing again and again shows just the opposite (they have to fight in several ways, including discursive procedures, in order to be sure that their favorite results ultimately be realized).

## **2. Instability and openness**

In Helbing and Kirman (2013) the notions of complexity and instability are linked. I will show the points of agreement and disagreement between my view and their position. The first thing to be noted is that my analysis centers on the “openness” of economic processes, while Helbing and Kirman focus on their “instability.” Although the two notions can be connected, they are indeed different. The “openness” originates in the insurmountable cognitive limitations of agents, ultimately grounded on ontological reasons, while “instability” that characterizes “complex dynamic systems” comes basically from two key features: a) excessive interconnection between the elements of the system (in this case, banks or financial firms); b) presence of big elements, with so substantial economic volume that they generate what the authors call the “too big to fail problem”. A system that has these properties

(like the current financial system in the dominant countries) can lead to undesirable domino and cascade effects.

The necessity of a new framework to approach economics has been demanded by Fullbrook (2013, 2014) and by Helbing and Kirman, when they refer, respectively, to the formation of “New Paradigm Economics” (NPE) and “New Economic Thinking”<sup>5</sup>. Our notion of an intervenible, open-ended process based on expectations does not incorporate the two above mentioned features (see Ivarola et al, 2013). But it might do so. And to show how both concepts (openness and instability) can be articulated would be an important contribution to the construction of a new philosophical approach to economics.

In our analysis, two sources for openness of economic processes are considered:

- a) Agents’ expectations
- b) Actors’ interventions

Although we acknowledge that changes in expectations can drive the process to different final states (even stagnation), we have not emphasized the phenomenon of instability. Actually, our exposition does not reveal the particular form the recent financial crisis has taken (nor the phenomenon of bubble formation). In particular, we have not shown (or mentioned) that the several ways in which changes in expectations can influence the process crucially depend on the type of relationships between the components (agents) of the system; and we have not remarked that the size of some of these agents may be central to the outcome of the whole process. This is an important aspect of the economic processes that has been correctly captured by Helbing and Kirman.

Although the notions of instability and openness are compatible and within real economies both phenomena are actually present, they are different and should be distinguished for analytical and practical purposes. Even if, as the authors suggest, to design a stable system were possible (one where no opportunities for undesirable effects, like domino or cascade, can occur), our analysis would still be worthwhile, in the sense that the process would remain open-ended and would be based on intervenible expectations.

Another important difference is that they do not distinguish, as we do, between agents and actors<sup>6</sup>. However, taking actors into account may be important for approaching a broad set of issues. In Ivarola et al (2013) the role of actors in the formation of expectations was pointed out, but we have not emphasized enough their influence in the construction of the relevant context (regulations, laws, institutions) that provide the frame in which those expectations are formed.

Actually, an important source of instability comes from actors’ interventions, even from those that are not agents in the strict sense of the term: communication media, corporations, unions and the like. Considering actors in such a broad sense may illuminate other sources of instability beyond those coming from firms and relations among them. Particularly, including

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<sup>5</sup> Several authors share this goal. Lawson has been advocating for a long time for a specific alternative (critical realism), that takes into account the ontological nature of social phenomena. Also Hodgson (2012) encourages the broadening of the conventional economic view incorporating psychological and institutional aspects, while Dow (2012a, 2012b) proposes an alternative pluralistic approach to mainstream vision of economic theory.

<sup>6</sup> This distinction is traced between *roles* played by economic subjects. Agents and actors are not mutually exclusive classes. A subject may belong to both of them as long as he performs both roles.

actors into the analysis allows the introduction of politics and conflicting interests into the approach to economic processes. It might be helpful for examining the kind of political and economic instability that we find in underdeveloped countries.

Actors' participation also enriches the discussion about forms of uncertainty in actual economies. Expectations are not something agents somehow form by themselves, but are based ultimately on the struggle among the actors in order to shape the context and influencing agents' expectations. How this confrontation will end is uncertain for the actors, a fact that reinforces the openness of economic processes. Uncertainty reappears here in a second level.

Conflictuality and uncertainty are the clue to understand why actors are not mere observers but active participants striving for influencing the outcome. Taking as given that stability benefits most economic agents, enforcing ways to stabilize these processes is most difficult because even when adequate knowledge of institutions is available, preventing swings hurts the interests of powerful speculators.

Perhaps the point at which our analysis diverges most from that offered by Helbing and Kirman is that they seem to believe that the main tool to stabilize the economic system is to acquire better and more "scientific" knowledge of its operations. They argue that rules and stabilizing institutions must be "tested" before being implemented. We welcome such tests, in case they are possible, but we think that, even if those tests were successfully conducted, the transition from experiment to practice faces two main problems. First, that of external validity (not yet satisfactorily solved). Second, and more importantly, we doubt that having well tested theories and models is necessary to implement the needed policies. A pre-scientific knowledge of both human behavior and the performance of institutions may be sufficient to start. Throughout the process there are always opportunities for corrections and for further action. In any case, none of these decisions are based on decisive "proofs" or tight valid demonstrations. This point will become clearer later when we introduce the notion of validating rationality.

### **3. Existence of transmission mechanisms**

According to the dominant view of financial markets, access to easy credit driven by central banks in both the U.S. and the developed countries of the European Union, should have led to economic growth. The transmission mechanism is the following: availability of easy credit (at rates of zero or near zero interest) will raise the price of stocks (including real estate within this category), generating a wealth effect that will in turn increase consumption and the GDP. See some testimonies.

"Before the current turmoil began, Federal Reserve Chairman Ben Bernanke's hope was that rising asset prices would lead to a 'wealth effect' that would encourage the American consumer to start spending again, and thus help the American economy finally leave the 'Great Recession' behind" (Keen, 2013, p. 3).

Alan Greenspan has been even more explicit.

“...the stock market is the really key player in the game of economic growth... The data shows that stock prices are not only a leading indicator of economic activity, they are a major cause of it. The statistics indicate that 6 percent of the change in GDP results from changes in market value of stocks and homes” (Quoted by Keen, 2013, p.3).

The statements of both Fed officials were not capricious or arbitrary, but were founded on the “conventional wisdom” provided by what were supposed to be the best available models about the operation of the financial system. Very schematically, according to these models, the structure of the mechanism is the following:

+Δ credit → +Δ prices of stocks → +Δ wealth → +Δ consumption → +Δ GDP

However, the implemented measures did not yield the expected results, finally generating the crisis. A more detailed picture of the facts that includes crucial information for understanding how the bubble is formed and why it is so precarious is this: easy access to credit implies borrowing from those who take it. Taking debt allows firms to make investment transactions that exceed their real estate (“leverage effect”), buying shares and raising their prices with their decision, then sell them with a return, and finally undertake a new operation of purchase and subsequent sale. Here is a synopsis of this alternative mechanism:

+Δ credit → +Δ debts → Leverage effect → +Δ buying assets → +Δ prices of assets → +Δ returns → +Δ buying assets → +Δ prices of assets → +Δ returns ..... → Bubble

### **Scheme 1**

Herein is the bubble: as demand for shares holds high their prices continue to rise and this opens up new business opportunities. However, the increase in stock prices is unrelated to any increase in the economy (GDP), which in the final period reached a 12:1 ratio! (Keen, 2013, p. 5.) Given the gap, the danger grows that at some point potential buyers may consider that such prices are unsustainable and can only move downwards. There begins the deflationary period (post-bubble). To make matters worse, an indebted society like that of the U.S.A, has a small portion of their personal income available for consumer spending. Consequently, it will fail to recover enough (Hudson, 2013). Against conventional wisdom that greater liquidity makes financial markets work better, many recent papers point out that the belief in this false idea, as well as the monetary policies it suggested were the triggering cause of the sequence of events that led to the crisis.

How much of “real” mechanisms and how much of open processes are these so called “economic mechanisms”? It is an important issue, because the more the processes resemble mechanisms the less relevant management activity becomes. If economic theory, qua science, presupposes the idea that underlying transmission mechanisms are working, the political management of the economy tends to become useless. As mentioned, trained economists are likely to model such mechanisms. It is important, therefore, to investigate the conditions that must be met for the occurrence of this type of regular event sequences. The texts to which we refer in this paper show some of them.

a) Extreme measures. White's paper provides an illustration of the consequences of extreme monetary policies. Loans at zero or near to zero interest rates are unable to stimulate the economy, whatever the authorities do in later stages. However, White suggests that more moderate policies could be managed successfully.

b) Absence of constraints imposed on banks and credit-takers. The granting of loans was not subject to reasonable restrictions. On the one hand, there was a poor discrimination about who qualified as creditworthy and who did not. On the other hand, loans were not restricted to a particular kind of use meant to enhance economic activity. In these circumstances, credits were used in speculative activities that did not generate employment.

c) Lack of regulations on the use of the owned resources, as well as on the size of companies and the kind of relations they can keep with each other. The colossal size of some companies and banks gives them a significant market power, transforming those markets in which they operate in imperfectly competitive markets. Moreover, some mega-firms have multiple connections with other companies whose conjoined capital and asset stocks largely exceed the total product of many countries. These circumstances give them a formidable extortive power, leading to the "too big to fail problem": authorities cannot let these firms go bankrupt because that would drag behind them many of the productive and financial systems.

Some consequences of points (a) to (c) have already been discussed. Here I want to focus on the social nature of socioeconomic sequences and the role of an ubiquitous crucial condition that allows the emergence of economic mechanisms. It has been argued that the presence of regulations and institutions *hinders* the goals pursued by individuals. For example, to quote a favorite example of Popper's (1996), consider the simple situation faced by a pedestrian trying to cross a highway. His options will be very different whether there is or not a pedestrian path. The path forces him to cross only at the designated place. This suggests that the number of choices available to the pedestrian appears to be linked positively with the absence of regulations, while their presence would impose limits on their movements across the road. Because the rules are in force an observer might anticipate where a pedestrian would cross to the other sidewalk. Including rules help to construct simple models of pedestrian behavior. Enforcing constraints to limit the set of choices an individual faces is a procedure that can be found both in real life and in conceptual representations (models).

It is not often noted, however, that a model may focus on a typical course of action (which is privileged over other possible sequences of events) incorporating a particular type of *de*-regulation. Indeed, starting with self-centered individuals, many theoretical economic models, representing transmission mechanisms (more complex and detailed versions of so-called "economic laws"), get these sequences of allegedly unavoidable events assuming the *absence* of (some type of crucial) regulations.

Let's see how it works. Full respect for private property means *absence of regulations that restrict the use of owned resources*. Obviously, if someone is self-centered, has access to a clearly optimal choice and there are no restrictions for taking it, he will certainly choose that option (whether or not it is collectively beneficial). You can then build a model that shows that, given certain changes in the situation agents will inevitably choose *this* option. A transmission mechanism emerges, which, in the manner of Mises, is presented as inevitable. No mention

is made that one of the premises of the alleged inevitability is the freedom given to the agent to do as he pleases with his property.

If given an extreme situation (like a flood or an earthquake) nothing prevents me from increasing the price of an essential commodity that I have for sale, being self-centered I will substantially raise the price. Here is a “mechanism” (increasing demand leads to price increases), asserted by the standard economic knowledge, which works in the case of natural disasters. However, if regulations against such behavior were enforced, the predicted increase would be prevented<sup>7</sup>.

Schematic representations, as illustrated in Scheme 1, seemingly regular mechanisms, are merely man-made sequences, which could be avoided if appropriate regulations designed to hinder collectively undesirable behaviors are taken into account. Scheme 1 is a diagram of a truncated open process (what is depicted is just one of the many branches of the tree of feasible sequences of events). There is no natural (inevitable) connection between self-centered agents and speculative activities.

No attempt is made here to address the complex question of which specific activities are collectively beneficial and which are not. That is the subject of further analysis. The core of my argument is that many sequences of events that are presented as *mechanisms* (i.e., as sequences of events organized in a stable way and leading to results known beforehand) in theoretical models are actually socially constructed by the presence (often tacit) of regulations and institutions that eliminate otherwise alternative options. My argument is against the alleged *naturalness* of social sequences modeled within theoretical models. These sequences do not reflect social laws (like physical laws), or mechanisms in the usual sense of the term (used in current mechanistic literature). When they are represented within theoretical models, they are not much more than modeled representations of truncated processes, which are open-ended in reality. Theoretical mechanisms are obtained assuming as “natural” and given (i.e., unchangeable as a matter of principle) institutional features that are actually historically determined and perfectly modifiable.

Someone may find it foolhardy to suggest that the principle of individual freedom for disposing of their own resources could be removed (and maybe should be challenged in particular circumstances). However, modern societies are characterized by the ubiquitous presence of restrictions upon individual behavior. Many sets of laws and regulations within a society have this limitative purpose. More importantly, the presence as well as the absence of restrictions on private property is strictly a social issue (i.e., the product of social conventions adopted on the basis of the existing balance of forces at the time regulations and norms are sanctioned). My main claim here is that conventional economic mechanisms are obtained assuming explicitly or tacitly crucial de-regulations (especially on big firms and mega-firms’ activities) as part and parcel of the sequences of events that generate regular economic phenomena. This happens both on models and on real economies.

The above considerations may be useful to address phenomena such as bubbles and the volatile nature of the current financial system. The absence of measures to regulate the market structure, especially the net of business connections, as well as the concentration of resources and the use that can legitimately be made of owned goods and capital, leaves the

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<sup>7</sup> It is interesting that the city of New York has legislation that prevents this type of self-centered behavior, regulating the prices of a set of highly needed goods with the arrival of winter.

door open to economic behavior with negative impact on growth and employment. To the extent that, as some authors argue, there can be a distinction between productive and speculative activities, what is required is the creation of institutional instruments to expand and facilitate the first type of activities and temper or prevent those of the second type (Reinert, 2013). This seems to require an extension of public law over private law.

#### **4. Validating rationality**

Rosenberg (2014) added his views to those that oppose the predominant way of modeling in economics and advocate the necessity of trying a different approach to social issues. Moreover, he focused not on the examination of representations, but in the analysis of economic processes themselves, which reaffirms the primacy of ontology over epistemology (a perspective supported by Lawson). This is the key to reversing what Fullbrook (2014) designated as “upside-down economics”. Although I agree with Rosenberg's critique of the extreme rationalism that pervades mainstream economic theory and share his claim that there are few opportunities for the uprising of regularities in human affairs I disagree in several aspects with his treatment of both points. First, he approaches social phenomena with tools taken from the natural sciences (now it is not physics but biology that provides the relevant paradigm). Moreover, in his approach deliberate action and intentionality, as such, does not play any role. From their point of view, to understand the endurance of economic relations all is needed is the reception they get from the “environment” (the utility economic institutions provide to their “consumers”). The characteristic traits of economic processes would then be the combination of unexpected changes (transformation or creation of economic institutions) and subsequent agents' response to those changes. Rosenberg's perspective is similar to that described by Alchian (1950), in which individuals do not adapt to the environment but are rather adopted by it. From this perspective there is no gain in distinguishing between agents and actors and no role for purposeful actions. Finally, while the presence of uncertainty is highlighted on Rosenberg's account, its only purpose is to dismiss the Rat-choice approach, not to point out a crucial characteristic feature of economic processes. Besides, he seems to believe that assuming uncertainty there is no room for rationality in the analysis of social phenomena.

My proposal seeks to put in the center of the analysis the specificity of social processes, while rescuing a role for deliberate rational action in economic processes. In particular, as was argued in section 3, social regularities can be deliberately constructed. Moreover, although Rosenberg is right in pointing out that much of human behavior is based on emotions and heuristics (“rules” in words of Keynes, 1937), the fact remains that individuals do use rational strategies designed to influence economic processes. These strategies are what I call *validating rationality*. In what follows I will briefly describe what this kind of rationality is. But first, let's see an approach to rationality I reject because of its incompatibility with the existence of uncertainty.

##### ***Deliberative and ex-ante rationality***

Savage's paradigm of decision making under uncertainty incorporates the main features of this type of rationality. It is assumed that the subject does not know what state of the world is actually in place, but he knows all the possible states and what the results of the various actions that may be undertaken would be if the world were in any of these states. Suppose, for simplicity's sake, there are only two states, S1 and S2, and three actions a1 to a3.

S	A	C
S1	a1	c1
	a2	c2
	a3	c3
S2	a1	c4
	a2	c5
	a3	c6

The subject does not know whether the world is at S1 or S2 states, but he knows that if it is S1 and he does action a1, the result that will be obtained is c1, while if the world is at S2 he will get c4. The exercise is repeated for the other alternatives. This model of decision making is based on three basic assumptions:

- 1) Ignorance of the prevailing state of the world;
- 2) Impotence to alter that state;
- 3) Knowledge of the laws of nature (i.e., the connections between actions and outcomes given the state of the world is supposed to be known).

Point (1) makes it explicit what the individual is uncertain about. He is not uncertain about all the possible states (that is known). What he does not know is which of them is actually in place. From (1) and (3) it follows that he does not know either which outcome he will get when performing an action. This model aims to clarify how and in what sense it might be said that an action undertaken before knowing what the prevailing state of the world is can be considered rational. I call it *an ex ante model of deliberative rationality*. To behave rationally all that is required is that subjects be consistent with their (subjective) beliefs about the states of the world and their expectations about the results they can get by acting in a certain way. In other words, to be rational is to select the prospect (lottery) that gives him higher expected utility. Perhaps, in the end, the subject discovers that the world was not as he thought and that, therefore, the resulting consequences were not what he had imagined, but this does not detract at all from the rationality of his initial decision.

### ***Validating rationality***

If we give up the assumption (2) that agents have no power over the states of the world, and consider that there is a time interval between the action taken and the outcome, other options become available for them. An individual (or a firm) can know what the impact on the world will be of *other* actions, taken after what we call here the “decision” in the strict sense has been adopted. Let’s suppose a lapse of time divided into two periods,  $t_0 - t_1$  and  $t_1 - t_2$ . In  $t_0$  a subject takes the decision a1, assuming the prevailing state of the world along  $t_0 - t_2$  will be S1 (the one in which c1 is expected). But then, he does not stay idle, but undertakes some

additional actions  $b_1, \dots, b_n$ , designed to produce (or help to create) the needed state  $S_1$ . These actions, additional to (and successive of) the initial decision, are aimed at the transformation of reality in a precise way in order to get the desired result. We may call them *validating actions*.

A good example of validating action is propaganda, which tries to install at the top of the agents' preferences a product whose production has already been decided (or has already been finished). Let's suppose that a bad decision has been taken. For instance, to produce a doll that nobody wants (something that is seen after the production process has come to an end). One solution is to change the preferences of the agents for this product. Changing preferences is an important way to change the states of the world. Remember that this was not a possibility within Savage's paradigm.

Propaganda is just an instance of a much wider repertoire of validating strategies. If a company decides to manufacture a car able to reach high speeds, it can try to ensure the existence of norms that will add value to the differential feature of its product. For instance, once its decision has been taken the company may decide to become engaged in aggressive lobbying in order to influence the sanction of new traffic rules that will be in force when the product reaches the market. The creation of new institutions is something alike to creating a complementary good for the one that is being sold.

Perfect competition models, which assume that agents lack market power, are in harmony with the *deliberative* and *ex ante* conception of rationality. The individual or the firm, making some calculations, take a decision at an initial time  $t_0$  and then cross their arms and wait to see what destiny has reserved for them when the time lapse ends. In a real, not perfectly competitive market, however, there is scope for considering a different notion of rationality. Mega-companies undertake actions to reduce the competitiveness of potential rivals. They can implement practical actions and strategies aimed at creating favorable conditions for obtaining the desired results. An agent is rational not merely because he is consistent or because he is capable of performing a maximizing calculation once his interests or priorities have been defined, but because he *knows how to meet his expectations*. And he *successfully meets them*. Agents' rationality is not now of the deliberative and *ex-ante* type, but rather of the *practical* and *ex-post* type. Rationality cannot consist in a mere deliberative process that ends when you have chosen the best option beforehand. Not under uncertainty. There are no good (or best) options that can be recognized *ex-ante*. *Good choices must be constructed*. The rational enterprise strives to transform reality in a way that validates its previous decisions. The rationality of the decision originally adopted as such is revealed only at the end of the process. The paradigm of business rationality is self-made prophecy (perhaps wishful thinking made real by self-effort).

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