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# Preface

The international financial crisis of 2008 painted the work of economists once more in a rather poor light. In the present case, prominent investors and academic economists—backed by Nobel Prize winners—joined forces and demanded a fundamental reorientation of economics. To underline their demand, they raised considerable amounts of money and established the *Institute for New Economic Thinking*.<sup>1</sup> George Soros, co-founder of the Institute, pointed at the heart of the matter: The neglect of (Knightian) uncertainty in economic models because economists with their

... quantitative methods cannot take into account any uncertainty that cannot be quantified. Colateralized Debt Obligations and Credit Default Swaps and risk management models produced by these quantitative methods played a nefarious role in the crash of 2008.<sup>2</sup>

In effect, Soros emphasised the same fundamental problem of economics, as did before him John Maynard Keynes after the Great Depression. Keynes accused, what he called, “classical theory” to be “. . . one of these pretty, polite techniques, which tries to deal with the present by abstracting from the fact that we know very little about the future.”<sup>3</sup> He helped himself by replacing the (neo-) classical assumption of optimising behaviour of individuals by simple, psychologically justified behavioural assumptions about consumer spending, investment expenditures and cash management. These assumptions, together with aggregating individual decision makers into sectors of consumers, firms and state, allowed Keynes and his immediate followers to describe complex national economies by mathematically simple circular flow models—known today as “hydraulic Keynesianism”—instead of dealing with the more difficult equations of general market

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<sup>1</sup> Institute for New Economic Thinking <Institute\_for\_New\_Economic\_Think@mail.vresp.com>

<sup>2</sup> Soros, Page 3 of 10 I.E. Cambridge Speech at 9 April 2010.

<sup>3</sup> J.M. Keynes, “The Theory of the Rate of Interest”, in: *The Lessons from Monetary Experience: Essays in Honour of Irving Fisher (1937)*, reprinted in: *J. M. Keynes Collected Writings*, Vol. XIV, 115.

equilibriums. Parameters of functional relationships were econometrically estimated, and the resulting models used for exercises in forecasting and “quantitative economic policy”. The problem of Knightian uncertainty crystallised in parameters like the “marginal propensity to consume”. With the advent of rational expectations and the microfoundation of macroeconomics, macroeconomic models became mathematically too specific and complicated in order to allow general solutions. Economists turned to numerical computation as a way of theorising. In effect, economists tried to make calculable the core problem of Keynes’s *General Theory*: Knightian uncertainty.

Thus, what shall we do? Two options are apparent: Firstly, to continue analysing economic developments on both the micro- and macro-level given their institutional framework, i.e. given the contents of contracts between individuals or legal frameworks of societies, and, secondly, to include contents of contracts and of legal frameworks into economic analysis. The reason is that social organisation—institutional choice—helps individuals to adapt effectively to unforeseen events, to the uncertainties of life in the sense of Knight or Keynes. In our opinion, this and not the much referred to “transaction costs” is the most interesting aspect of the New Institutional Economics movement.

Even though the term “New Institutional Economics” is being used in a rather general way, we may say that it deals with the economic analysis of

- *Formal institutions* like property rights, contractual and noncontractual obligations, the organisation of national states or international agreements between them plus
- *Informal institutions* like customs, implicit agreements, organisational culture, etc.

Despite its applicability in a wide range of problems, the corresponding use of new institutional economic research remains rather limited: on the micro-level largely to issues of industrial organisation and on the macro-level to issues of economic history or development economics. In our opinion, new institutional economic methodology can be applied to virtually all problems of economic life that deal with organisational issues in the face of Knightian uncertainty. The present Essays are hoped to demonstrate this and that NIE offers analytic potentialities whose less sharp results are more reliable than the sharp outcomes of mainstream economic models.



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