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Exploring Pluralist Economics: The Case of the Minsky-Veblen Cycles

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***Abstract*:** This paper provides an introduction to the Minsky-Veblen Cycles as a specific example of pluralist economic thinking in the context of the recent global economic crisis. It illustrates how pluralism can be applied to economic research. Specifically, the Minsky-Veblen Cycles combine three elements of institutional and post-Keynesian thought to explain key features of the current crisis. These elements are (1) John Maynard Keynes's postulate of *effective demand*, (2) Hyman Minsky's *financial instability hypothesis*, and (3) Thorstein Veblen's concept of *conspicuous consumption*. In this paper, we have a two-fold approach to them: First, we systematize the connection between the Minsky-Veblen Cycles as a theoretical argument and the epistemological rationale of a pluralist approach to economics. Second, we contrast the implications of our approach for incorporating behavioral assumptions in macroeconomic arguments to mainstream claims for a "microfoundation" of macroeconomic theory.

Keywords: conspicuous consumption, consumer credit, financial instability hypothesis, income inequality, microfoundations, pluralist economics

JEL Classification Codes: B40, B52, D11, E12, G01

"Pluralism" has become a key concept in heterodox economic thought, signaling the need for more intense cooperation across traditional theoretical cleavages. While the discussion of pluralism in (heterodox) economics is well advanced in terms of its epistemological exposition (e.g., Dobusch and Kapeller 2012; Dow 2004; Garnett, Olsen and Starr 2010), the field still lacks clear-cut examples with regard to pluralist research practice. In what follows, we suggest interpreting the theory of the Minsky-Veblen Cycles (Kapeller and Schütz 2012) as an archetypical example for the way a pluralist approach can create novel insights into such economic processes as the recent financial crisis.

In traditional terms, we take the relationship between institutionalist and post-Keynesian economics as our starting point. There are many acknowledged conceptual similarities between these two schools of thought, which are often applied in

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combination when answering practical economic questions. Institutional economists tend to draw on post-Keynesian arguments when discussing macroeconomic issues and post-Keynesian economists often rely on institutionalist concepts to answer microeconomic questions (e.g., Dosi, Fagiolo and Roventini 2010; Lavoie 1992). However, most of the time, such contributions are not intended to highlight theoretical complementarities, but rather use these external concepts to compensate for blind spots in their own approach. In contrast, the case of the Minsky-Veblen Cycles provides an example for a combination of different elements from these traditions, which prove to be *complementary* in the sense that their combination creates novel, empirically relevant results that cannot be reached without relying on each other.

The next section of this paper introduces our understanding of pluralism in economics and contextualizes some basic features of the analyzed model from a pluralist perspective. Section two then discusses the main theoretical mechanisms embedded in the underlying model in a non-technical manner. Section three specifically asks how the interaction between the theoretical arguments in the case of the Minsky-Veblen Cycles is to be understood with respect to the mainstream claim of providing macroeconomic theory with a microeconomic "foundation." The final section offers some concluding thoughts.

Pluralist Economics and the Case of Interested Pluralism

Our starting point in applying pluralism to economic thought is termed "interested pluralism." Interested pluralism strives for "constructive interaction between different theoretical traditions in order to come up with an improved and expanded set of relevant explanatory statements" and the development of a "pluralist paradigm" (Dobusch and Kapeller 2012, 1043-1044). In this framework, the combination of theoretical arguments of different economic approaches allows for a variety of specific research strategies depending on the theoretical relationships of the combined statements. These relationships are estimated by logical comparison whose result, in turn, enables us to apply different research strategies as depicted in Table 1.

Table 1. Strategies for Comparing Theoretical Statements of Different Economic Paradigms

#	Comparison between theoretical statements		Pluralist research practices / strategies		
(1)	→←	Identical	(a) Integration	(b) Division of labor	(c) Diversification
(2)	↗↖	Convergent			
(3)	↑↑	Compatible			
(4)	O O	Neutral			
(5)	↖↗	Divergent	(d) Test of conflicting hypotheses		
(6)	←→	Contradictory			

Source: Leonhard Dobusch and Jakob Kapeller (2012, 1050).

Essentially, the theoretical model of the Minsky-Veblen Cycles combines three basic theoretical arguments: namely, John Maynard Keynes's ([1936] 1997) postulate of *effective demand*, Hyman Minsky's (1986) *financial instability hypothesis*, and Thorstein Veblen's ([1899] 1970) concept of *conspicuous consumption*. These concepts constitute the fundament of a macroeconomic model exhibiting cyclical behavior in the form of an output-debt cycle. Keynes, Minsky, and Veblen's ideas are clearly compatible: They talk about different, but related aspects of economic life — consumer demand (Veblen), aggregate demand (Keynes), and the financial sector (Minsky), all of which play a key role in understanding the recent financial crisis and the associated economic downturn. Compatible theoretical statements like these leave us with two basic options for conceptualizing research: the goal of the division of labor, on one hand, and the task of integrating these theoretical conceptions, on the other. The case of the Minsky-Veblen Cycles represents an example of such an integrative strategy, where assumptions on a related subject are put together in a sensible way to generate novel explanatory statements. While this approach is not the only way to achieve theoretical integration, it seems to be a promising strategy for evaluating the compatibility of statements that are unrelated but not contradictory (Dobusch and Kapeller 2012). The next section illustrates the argument on the Minsky-Veblen Cycles in more detail.

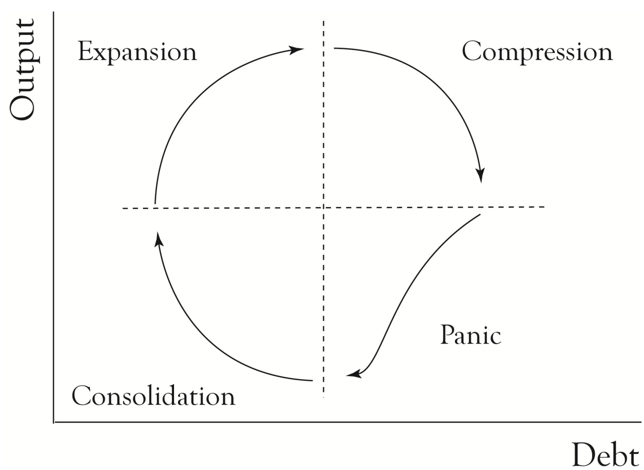
Understanding the Recent Crisis via the Minsky-Veblen Cycles: A Case of Interested Pluralism

A main claim underlying the idea of the Minsky-Veblen Cycles is that the recent crisis can be interpreted as part of a cycle, as represented by Figure 1. In this cycle, it all starts with an increase in household debt, which leads to a (debt-driven) economic *expansion*. This expansion, however, is followed by an economic *contraction*, where access to credit decreases and indebted households have to cut expenditures while still facing rising debt levels. Eventually, the process culminates in a phase of *panic*, where some households go bankrupt, and banks begin to realize the increase in systemic risk. This then triggers a *consolidation* phase, where remaining debts are repaid and the economy slowly recovers.

The period preceding the outbreak of the crisis in 2007 witnessed substantial and widespread changes in the financial sector, on one hand, and a significant shift in income distribution, on the other. Among the changes in the financial sector were increasing deregulation (e.g., the repeal of the Glass-Steagall Act by the Clinton administration in the USA) and a range of "financial innovations," including the introduction of collateralized-debt obligations and credit-default swaps. At the same time, income inequality in the US increased, while aggregate consumption demand remained a main driving force of economic growth.[1] Thus, we may infer that consumption levels have been sustained by an increase in consumer credit, which can also be observed empirically (Barba and Pivetti 2009; Boushey and Weller 2006; Christen and Morgan 2005; Krueger and Perri 2006; van Treeck 2012).

Minsky (1986) argued that innovation and deregulation is exactly what one would expect in a period of relative economic stability. This is so, according to him, because financial agents tend to forget past disasters in times of stability and strive for higher rates of return, thereby adopting more aggressive financing practices and creating new financial instruments. Hence, stability breeds instability. An increased availability of consumer credit by itself, however, can only be a partial explanation for the remarkable increase in debt-financed consumption, since it only means more *potential* credit. But in order to become *actual* credit, it has to be matched by a sufficiently large demand. In this context, the substantial changes in income distribution play a key role. Generally, any significant increase in income inequality should lead to a decline in aggregate consumption (since the marginal propensity to consume declines with rising income). However, a rise in consumption in such a context can be explained from a Veblenian perspective. When income inequality increases and some households lose income relative to others, with whom they share a common social identity (Hogg and Terry 2000), those falling behind in income will try hard not to reduce their visible amount of consumption. As Veblen puts it, "[v]ery much of squalor and discomfort will be endured before the last pretense of pecuniary decency is put away" ([1899] 1970, 70).

Figure 1. A Stylized Representation of Minsky-Veblen Cycles in the Output-Debt Space

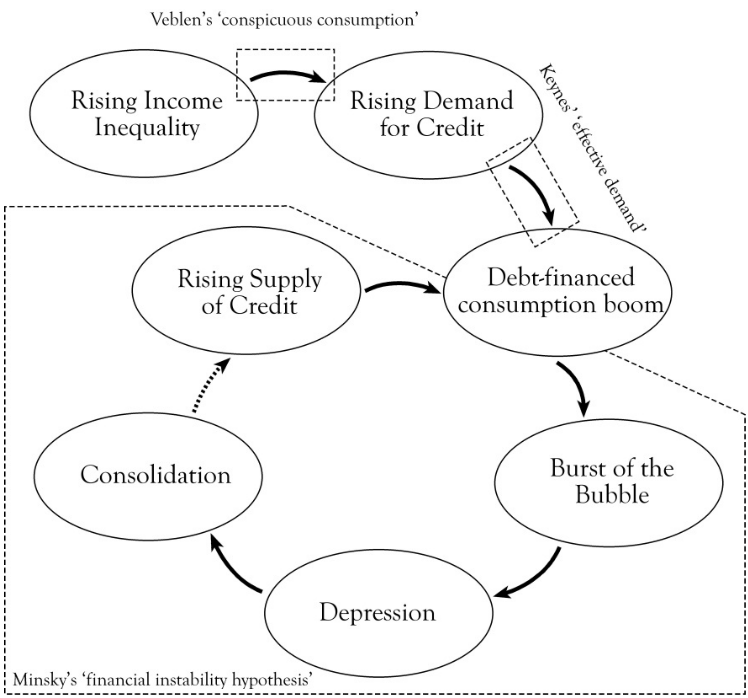


Source: Jakob Kapeller and Bernhard Schütz (2012, 19).

In this sense, the concept of *conspicuous consumption* can be used to explain the rise in *demand* for certain kinds of credit arrangements. If increasing demand for loans is matched by a high supply, credit-financed consumption will increase. That will lead — in accordance with Keynes's principle of effective demand and the associated multiplier process — to a self-propagating boom for some time. However, in each boom financed this way, there will come a time when creditors get more anxious as the financial position of their clients deteriorates. Thus, indebted households will have to reduce consumption when credit becomes limited.

As the boom fades and refinancing — that is, acquiring new loans to roll over old ones — becomes more costly, the economy enters a period of contraction. The contraction stage eventually concludes with a short but intensive phase of panic that finally culminates into depression. Then, following a long period of consolidation, when outstanding loans are repaid and balance sheets restructured, creditors and regulators forget the past disaster and regain confidence. If the problem of deteriorated distribution of income has not been solved, or has worsened, the resulting increase in credit supply will again meet a high demand for credit to finance consumption. Then, history will repeat itself. This is what we call the *theory of the Minsky-Veblen Cycles*. Figure 2 provides a graphical illustration of how the main theoretical mechanisms of the underlying model interact and help explain the driving forces of the recent crisis. (Further elaboration as well as simulations, within a post-Keynesian stock-flow consistent model of effective demand, can be found in Kapeller and Schütz 2012).

Figure 2. Main Building Blocks and Mechanisms in a Minsky-Veblen Framework



Behavioral Enrichment vs. Microfoundations

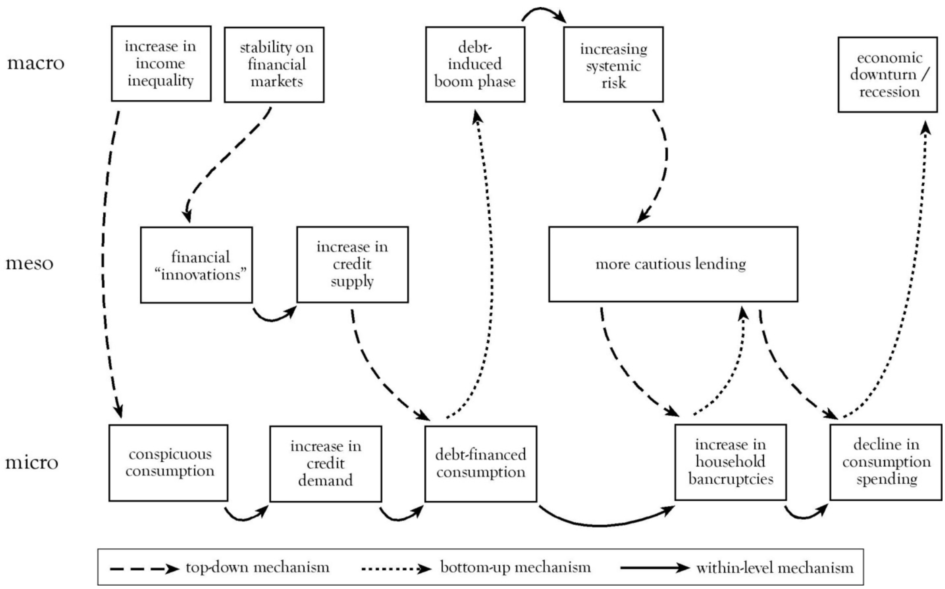
Our argument regarding the Minsky-Veblen Cycles combines assumptions about macroeconomic phenomena (e.g., business cycles and financial market instability) with observations of processes on institutional (e.g., excessive risk taking by banks) as well as individual (e.g., conspicuous consumption) levels. In this respect, the case of the Minsky-Veblen Cycles stands in contrast to the "microfoundations" approach advanced by most mainstream economists, which starts at the individual level and argues that macroeconomic outcomes are fully determined by decisions on the micro-level. From this perspective, any sound analysis of macroeconomic phenomena is simply based on the aggregation of individual decisions (Hoover 2010). This approach, however, ignores the fallacy of composition and other aggregation problems and, according to its critics, exemplifies the perils of reductionism (King 2008a). A well-known example of the fallacy of composition is the paradox of thrift: Whereas a higher saving propensity will lead to more savings at the individual level, at the macro-level it will result in less consumption demand, thereby causing a decrease in both firm-production and aggregate income. Lower income means that individuals cannot realize their saving plans. In this sense, "microfoundations" seem to reduce macroeconomics to microeconomics. Our approach, on the other hand, enriches macroeconomic theory by adding more realistic assumptions on micro-level behavior, leading to an interaction between theoretical arguments on different levels, as opposed to the bottom-up determination proposed by neoclassical economics.

While most economists tend to divide the economy into micro and macro, it seems appropriate — as institutional and evolutionary economists have repeatedly suggested (e.g., Dopfer, Foster and Potts 2004; Elsner 2007) — to add an extra layer to our analysis: the *meso*-level. In the case of the Minsky-Veblen Cycles, causal relationships appear within as well as between these levels and the direction of causality can be both top-down and bottom-up (Bunge 1996). The main starting point in our model is the combination of increasing inequality in society and a period of relative financial stability, both located at the macro-level that set the events in motion. Figure 3 provides a more detailed overview about the interacting mechanisms and their location with respect to the level of analysis.

In the figure, increasing income inequality on the macro-level leads to an increase in conspicuous consumption on the micro-level (top-down mechanism), inducing increasing demand for credit at this level (within-level mechanism). On the other hand, stability on financial markets on the macro-level is the basis for increased risk-taking through financial "innovations" at the meso-level. This points to an obvious parallel between the Minskyan concept of the foundation of financial innovations and evolutionary economic theory since both approaches perceive stability as a strong basis for promoting innovation (Loasby 1999) which, in turn, leads to instability (very much as in the Minskyan proverb "stability breeds instability"). In this sense Minsky — who is generally perceived as a Keynesian economist — could also be called an evolutionary economist.

The main effect of these financial innovations is an increase in the available credit supply. In combination with increased demand for consumer credit, this causes a debt-financed consumption boom at the macro-level (bottom-up mechanism). This process generates a gradual rise in systemic risk that, at some point, will lead to more cautious lending behavior of banks (meso-level). Financing consumption through debt brings with it the risk of bankruptcy, which is further increased when banks become more cautious (interest rates move up and refinancing is more difficult to achieve). As the number of bankruptcies grows and banks lend more conservatively, individual consumption will decline, thereby triggering an economic downturn at the macro-level.

Figure 3. Minsky-Veblen Cycles in a Micro-Meso-Macro Framework



In this sense, we agree with John E. King (2008b, 3) that "consistency between microeconomics and macroeconomics … does not entail that the former is the foundation of the latter. … [T]he fact that there is (or may be, or appears to be) some inconsistency between two related bodies of knowledge, A and B, does not entail that A must become the foundation for B, or for that matter that B must become the foundation for A." In this context, the example of the Minsky-Veblen Cycles provides a conceptual alternative to the reductionist program of neoclassical economics by allowing for various directions of causality that lead to mutual theoretical enrichment.

Conclusions

In this paper we tried to make a case for interested pluralism in economics. This approach suggests that using compatible arguments from different schools of thought can lead to novel insights, not attainable conventionally. To make a case for interested pluralism, we used the theory of the Minsky-Veblen Cycles as an illustrative example. In other words, applying Veblen's theory of conspicuous consumption provides an explanation for the remarkable increase in credit demand, while Minsky's financial instability hypothesis gives a sensible explanation for the rise (and subsequent fall) in credit supply. Keynes's theory of effective demand, on the other hand, explains how the former two concepts give rise to booms and depressions.

The scope of the Minsky-Veblen Cycles, therefore, is not limited to the recent crisis. For example, the Great Depression followed a similar pattern in being preceded by an increase in income inequality (Galbraith 1997; Piketty and Saez 2003), financial innovations (installment purchase in the retail sector), and growing indebtedness of households (Brown 1997). Similarly, the Japanese slump in the 1990s was accompanied by rising income inequality (Tachibanaki 2005), increasing supply of credit due to innovation and deregulation in the consumer credit sector (Alexander and Oh 1989), and growing indebtedness of households (Horioka 2012), although other factors (e.g., increased debt by firms), not incorporated in our Minsky-Veblen Cycles argument, played a significant role. In sum, however, we suggest that the theory of the Minsky-Veblen Cycles not only captures important aspects of the recent crisis — especially in the US — but also provides an interesting and promising archetype for a pluralist approach to economic thinking.

Note

1. According to *State of Working America*, real family income of the lowest quintile was only 0.6 percent higher in 2007 than it was in 1979, while for the top quintile the increase was 51.7 percent. Incomes of quintiles 2-4 increased by 11 percent, 18 percent, and 28.2 percent respectively (see http://stateofworkingamerica.org/chart/swa-income-table-2-1-average-family-income/).

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