Proposal for Special Session EAEPE 2018

Session title:

Evolutionary models and the relation between financial and real markets

Session organizers:

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EAEPE research area:

RA[S] Evolutionary Economic Simulation

Possible keynotes:

Evolutionary Macro: Andrea Teglio
Evolutionary Finance: Giulio Bottazzi

Possible special issue (already in the discussion phase with the editors):

Journal of Evolutionary Economics

Topic description

According to Bagehot's classical view, the financial system is able to foster economic growth by pooling savings and allocating them to the most efficient firms. Such view is shared and enriched by Joseph Schumpeter in his 1911 book "The Theory of Economic Development": financial institutions act as intermediaries between innovative entrepreneurs and owners of capital. Thus, collecting resources and lending them to firms, finance helps to sustain innovation, the engine of economic growth. However, the great depression, and the ensuing collapse of the stock market, led many scholars to cast doubts on the primary role of finance in supporting growth. As argued by Joan Robinson in "The Rate of Interest and Other Essays" (1952): "where enterprise leads, finance follows".

As the debate proceeded without a clear winner in the scientific literature, the first view came to dominate the economic policy arena. As a result, in the last 50 years firms, industries and countries have become more indebted and more dependent from financial activities, constituting a phenomenon dubbed as financialization (see Epstein, 2005). Furthermore, the long and tranquil period of the great moderation, together with the reassuring results coming from economic theory about the ability of markets to select for the most accurate investors, installed also in the scientific debate the naive belief that the strong relations between financial and real economic sectors was nothing but welcome: finance can make markets complete and more informationally efficient, empowering in turn economic growth.

In 2007, when the great financial crisis came, fallacies in these last two arguments and in the economic theory laying behind them have emerged and shown some of the mechanisms that might induce persistent mispricing, financial crises, and prolonged recessions. However, most of these mechanisms concerning generation and transmission of shocks between the financial and the real sectors are yet to be completely grasped or explored.

With this session, we aim at debating some of these undisclosed economic mechanisms. The session has therefore two aims:

1. to highlight and provide a better understanding of the mechanisms underlying financial and real activities which generate and amplify unpleasant economic and financial conditions by destabilizing either of the two sectors and by contaminating also the other one;
2. to attempt at better designing economic policies that could prevent or mitigate crises.

In particular, with this special session we focus on capturing these mechanisms by means of agent-based computational economics and finance models (Kirman 1992, Colander et al. 2008, Hommes 2013, Evstigneev et al. 2009). These models indeed offer a sufficient degree of flexibility to examine and study the interplay between financial markets and the real economy.

Questions of particular importance in this area of research, that we would like to see addressed in this special session, might involve (but are not limited to) the following ones:

1. Which elements are key to understand how shocks within either the financial or the real sector are generated and amplified?
2. What are the channels by which finance might affect the real markets? What are instead the ones by which the real economy might affect the financial markets?
3. Is is possible to find a balance between the financial activity and economic growth? If yes, what does a lack of it implies?
4. Can financial activity affect the dynamics of an industry? Do credit constraints matter in the process of industry evolution?
5. Is asset prices stability important for the general economic stability? Shall asset price stability become a new policy objective?
6. Can financial instrument based wage schemes align the incentives of managers, workers and owners of the firms? If yes, what are the implication on functional inequality and on wage differentials?