TWO VIEWS OF THE FINANCIAL CRISIS: EQUILIBRIUM THEORY AND REFLEXIVITY THEORY

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Current work on the financial crisis is focused on recapitalizing the banking system in order to increase lending and on stimulating the economy through fiscal policy, such as spending on roads and bridges. An increase in regulation of the financial sector is certain. However, little discussion is being given to expanding economic theory both to guide regulatory changes and to help us better understand the workings of economic systems in general. George Soros's suggestion of a change from equilibrium theory to reflexivity theory is the most prominent current proposal to expand economic theory to encompass the current crisis. Soros' proposal has not yet been widely discussed both because it requires a major change in the underlying model of economic activity and because it requires an expansion of the philosophy of science. This paper will describe the models and assumptions underlying equilibrium theory and reflexivity theory, will explain the financial crisis from both perspectives and will explain why Soros's suggestion for expanding economic theory is quite compatible with recent developments in the philosophy of science.