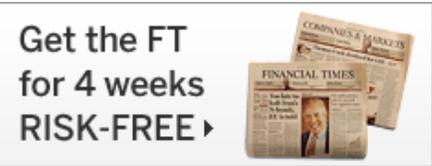


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## FINANCIAL TIMES

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### An economics of magical thinking

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*By Roman Frydman and Michael D. Goldberg*

Confidence seems to be returning to markets almost everywhere, but the debates about what caused the worst crisis since the Great Depression show no sign of letting up. Instead, the spotlight has shifted from bankers, financial engineers and regulators to economists and their theories. This is not a moment too soon. These theories continue to shape the debate about fiscal stimulus, financial reform, and, more broadly, the future of capitalism, which means that they remain a danger to all concerned.

Unfortunately, the assumptions that underpin these theories are largely inscrutable to those without a Ph.D. in economics. Indeed, the debate is full of terms that mean one thing to the uninitiated and quite another to economists.

Consider "rationality." Webster's Dictionary defines it as "reasonableness." By contrast, for economists, a "rational individual" is not merely reasonable; he or she is someone who behaves in accordance with a mathematical model of individual decision-making that economists have agreed to call "rational."

The centrepiece of this standard of rationality, the so-called "Rational Expectations Hypothesis", presumes that economists can model exactly how rational individuals comprehend the future. In a bit of magical thinking, it supposes that each of the many models devised by economists provides the "true" account of how market outcomes, such as asset prices, will unfold over time.

The economics literature is full of different models, each one assuming that it adequately captures how all rational market participants make decisions. Although the free-market Chicago school, neo-Keynesianism, and behavioural finance are quite different in other respects, each assumes the same REH-based standard of

rationality.

In other words, REH-based models ignore markets' very *raison d'être*: no one, as Friedrich Hayek pointed out, can have access to the “totality” of knowledge and information dispersed throughout the economy. Similarly, as John Maynard Keynes and Karl Popper showed, we cannot rationally predict the future course of our knowledge. Today's models of rational decision-making ignore these well-known arguments.

The unreasonableness of this standard of rationality helps to explain why macroeconomists of all camps and finance theorists find it hard to account for swings in market outcomes. Even more pernicious, despite these difficulties, their models supposedly provide a “scientific” basis for judging the proper roles of the market and the state in a modern economy.

But incoherent premises lead to absurd conclusions – for example, that unfettered financial markets set asset prices nearly perfectly at their “true” fundamental value. If so, the state should drastically curtail its supervision of the financial system. Unfortunately, many officials came to believe this claim, known as the “efficient markets hypothesis,” resulting in the widespread deregulation of the late 1990s and early 2000s. That made the crisis more likely, if not inevitable.

Public opinion has swung to the other extreme, as complacency about the need for financial regulation has been replaced by calls for greater oversight by the state to control the unstable behaviour of financial markets.

Behavioural economists have uncovered much evidence that market participants do not act like conventional economists would predict “rational individuals” to act. But, instead of jettisoning the bogus standard of rationality underlying those predictions, behavioral economists have clung to it. They interpret their empirical findings to mean that many market participants are irrational, prone to emotion, or ignore economic fundamentals for other reasons. Once these individuals dominate the “rational” participants, they push asset prices away from their “true” fundamental values.

The behavioural view suggests that swings in asset prices serve no useful social function. If the state could somehow eliminate them through a large intervention, or ban irrational players by imposing strong regulatory measures, the “rational” players could reassert their control and markets would return to their normal state of setting prices at their “true” values.

This is implausible, because an exact model of rational decision-making is beyond the capacity of economists – or anyone else – to formulate. Once economists recognise that they cannot explain exactly how reasonable individuals make

decisions and how market outcomes unfold over time, we will no longer be stuck with two polar extremes concerning the relative roles of the market and the state.

For the most part, asset prices undergo swings because participants must cope with ever-imperfect knowledge about the fundamentals that drive prices in the first place. So long as these swings remain within reasonable bounds, the state should limit its involvement to ensuring transparency and eliminating market failures.

But sometimes price swings become excessive, as recent experience painfully shows. Even accepting that officials must cope with ever-imperfect knowledge, they can implement measures – such as guidance ranges for asset prices and changes in capital and margin requirements that depend on whether these prices are too high or too low – to dampen excessive swings.

Such measures require policymakers to exercise discretion, rather than simply rely on fixed rules. That might not please most economists, but it would leave the market to allocate capital while holding out the possibility of reducing the social costs that arise when asset swings continue for too long and then end, as they inevitably do, in sharp reversals.

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