OPINION

Should the Financial Crisis and Historic Recession of 2007-2009 Change the Practice of Economics?

BY JOHN A. WEINBERG

Of course it should, and it will. As our cover story in this issue of *Region Focus* makes clear, the economics profession has always learned from events. And events of the magnitude and uniqueness as those seen in the period we've just come through can have a profound impact on how scholars and policy analysts frame and approach questions. For instance, the discipline is still learning about and adapting its work in response to the Great Depression, as debates continue regarding its causes, the effectiveness of policy responses, and how it compares to other significant contractions throughout history and around the world.

But I think those who foresee wholesale change in economic science are likely to be disappointed. The events of the last few years are not cause to throw out the prevailing paradigm in economic research — the notion that resource allocation can be understood in the context of individual optimization, with the reconciliation of conflicting goals being achieved through the equilibrium of a market mechanism. That itself is a pretty big tent, and it contains within it many lines of research and ideas that may prove useful in making sense of our extraordinary recent past.

Of particular interest in the wake of the financial crisis is the profession's approach to the study of financial markets and institutions. A caricatured depiction of the discipline's approach to financial market behavior would be to say that economists put too much weight on the efficient markets hypothesis and therefore missed indicators of dysfunction in markets. But the efficient markets hypothesis — roughly stated, that well-functioning markets do a good job of incorporating relevant information about fundamentals into asset prices — is really just a benchmark against which to measure observed financial market performance. One important line of research in the mainstream of financial economics is to take apparent deviations from market efficiency — evidence of mispriced assets — seriously, and to seek to understand the frictions that cause observed behavior to differ from the benchmark.

There are two narratives about the financial crisis that represent different views about which forces caused markets and institutions to function so poorly. Both of these narratives occupy places in the mainstream of financial economics. One is that financial fragility results from externalities in the distribution of risk in markets. These externalities have to do with the effects of one firm's performance — especially when it incurs large losses — on another's condition. Because firms don't take these external effects into account, they take on more risk than they otherwise would. This results also in the mispricing of risk. This narrative is really just a version of a concept — externalities — which has been a part of mainstream economic thought since at least the late 1890s when Alfred Marshall formally identified the issue and then his student Arthur Pigou further developed the idea and its potential implications for public policy. There is an active body of theoretical research articulating the conditions under which such systemic externalities might arise, although empirical validation has proved a challenge.

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An alternative, although not mutually exclusive narrative, suggests that the mispricing of risk and the associated tendency of firms to take on too much risk is the result of government policy. In particular, if market participants believe that the government will protect firms or their creditors from severe losses in the event of a financial crisis, then they will tend to underweight risk in making their investment decisions. Just like externalities, this will lead to the underpricing of risk. This moral hazard view of financial market dysfunction has also been a part of mainstream research for a long time.

So economists were working out ideas about financial instability well before the crisis. Unfortunately, that work had not yet gotten us to the point of being able to quantify the effects of either externalities or moral hazard. The events of the last few years will have a powerful influence on how these and related lines of research continue, and should help us better understand the relative importance of alternative financial market imperfections. **RF**

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