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Back to school

Economists rethink theories in light of global crisis

By BETH GARDINER

On top of the devastation it wreaked on markets, jobs and human lives, the global financial crisis has turned the field of economics, and particularly the study of finance, on its head.

Nearly three years after the crisis began, business school academics are sifting through the wreckage of long-held theories and developing new ideas.

Certainties about the healthy functioning of always-efficient, rational markets were shattered by the upheaval. B-school professors, along with their colleagues in university economics departments, are now rethinking models that businesses, investors and government saw as sacrosanct for decades.

Rewriting the textbooks and developing new approaches to replace those that no longer seem credible will be a long process. Those in the field are divided about just how much of the old thinking needs to be discarded, as well as which new path holds the greatest promise for understanding what caused the financial and economic crises and preventing them from recurring.

"There's been a very influential part of economics headed toward the view that markets can do no wrong, efficient market hypothesis," a view that gained great influence during the long boom period, says Alan Manning, a professor at the London School of Economics. Now, "the pendulum has swung back. Because obviously the view that markets can never make a mess of things doesn't look quite so credible."

The center of gravity has shifted to those who study how markets can go wrong and how best to regulate them, he says.

INSEAD

Denis Gromb of INSEAD

Central tenets like the law of one price, which holds that markets will always ensure two similar assets have similar prices, were called into question by the crisis and the bubbles that preceded it, says Denis Gromb, finance professor at INSEAD business school in Fontainebleau, France.

The overvaluation of many stocks during the boom years and then widespread undervaluation as markets sank in 2008 and 2009 both pose big challenges to standard theories that hold that an asset's price reflects its fundamental value, he says.

"Some say it's a slap in the face, so we need to go completely back to the drawing board, others are less willing to concede that," he says. "My own view is that there were big enough deviations that this really calls for a big change in the paradigm."

The big task now is to find the patterns in what can look like chaos and build new models that do a better job of reflecting the realities of markets.

Some financial economists are working within the framework of standard theories' belief in the rationality of economic actors' pursuit of self-interest, but broadening them with new ideas about what those actors want, Dr. Gromb says. On the other hand, behavioral finance, which has gained ground since the crisis, rejects the idea of purely rational activity and incorporates the psychological factors that also drive market participants.

Dr. Gromb says his own work took a third course, retaining the belief in rationality but focusing on constraints that can prevent the institutional investors who account for a large slice of market activity from acting in their own best interest. One such constraint: insufficient access to finance.

Ben Watkins

Michael Kitson of Cambridge

Michael Kitson, a macroeconomics lecturer at the University of Cambridge's Judge Business School, says the field had become far too dependent on mathematical modeling, and needs to open up to different methodologies as well as diverse schools of thought.

"Economics needs to become broader, and less arrogant," he says. "It doesn't always have the explanations for human behavior."

While business schools tend to be more grounded in the real world, the abstractions prevalent in economics departments had filtered into their halls too, Mr. Kitson says.

Bill Janeway, a senior adviser at the Warburg Pincus private-equity firm and member of the Judge school's advisory board, says economics had become far too estranged from the study of the financial sector, boiling its input down to little more than a single interest rate.

"If we've learned anything in the last three years, it's that what happens in the financial markets matters enormously, decisively, for employment, production, profits, wages, the attributes of the real economy," he says. "Infusing macroeconomics with mechanisms through which credit conditions, financial valuations, will interact with the real factors is absolutely essential."

Scholars on both sides of the Atlantic, he says, have made progress with models that take account of the real-life complexities of financial markets, which are rife with disagreement and diversity, rather than simply explaining away any divergence from so-called rational pricing.

At the National University of Singapore Business School, Dean Bernard Yeung says the old economic theories didn't need to be scrapped so much as applied more carefully. "So far we are not writing new models, we are just trying to find ways to make students see things in a bigger picture," he says. Adding history into the curriculum has been one good way to do that, he adds.

The biggest shifts in economic thinking have generally come after crises, Mr. Kitson says, recalling the rise of Keynesianism following the Great Depression and monetarism after the stagflation of the 1970s. But this time around, mathematical economics may be hard to topple, he says.

Most major university economics departments are dominated by the mathematical approach, as are the journals in which academics must publish if they want to advance, he says.

"The problem with economists is they believe the whole world operates according to their models," argues Mr. Kitson. "We need a bit more variety and a bit more pluralism. Not just there's a problem and we solve the equation and get the answer."

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