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10-30-2007

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Recommended Citation
Wright, Lori, "UNH Professor's New Book Offers Fresh Way To Think About Markets" (2007). *UNH Today*. 933.
https://scholars.unh.edu/news/933

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UNH Professor's New Book Offers Fresh Way To Think About Markets

Nobel Prize Winners Praise 'Imperfect Knowledge Economics'

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October 30, 2007

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DURHAM, N.H. – Michael Goldberg, associate professor of economics at the University of New Hampshire Whittemore School of Business and Economics, has co-authored a new book that offers a fresh way to think about markets and represents a potential turning point in economics.

Posing a major challenge to economic orthodoxy, "Imperfect Knowledge Economics" asserts that exact models of purposeful human behavior are beyond the reach of economic analysis. Goldberg and co-author Roman Frydman, professor of economics at New York University, argue that the longstanding empirical failures of conventional economic models stem from their futile efforts to make exact predictions about the consequences of rational, self-interested behavior. Such predictions disregard the importance of individual creativity and unforeseeable sociopolitical change, thus usually failing to predict how markets behave.

"Economists mistakenly believe that they have found the way to specify how 'rational' individuals are supposed to behave. As a result, the failure of their models to explain fluctuations in asset markets leads them to conclude that participants in these markets are 'irrational' and that fundamentals such as interest rates and income growth, do not matter. But Roman and I argue in our book that there is a much more plausible interpretation: conventional economic models are just the wrong theory of how rational individuals behave and how fundamentals matter," Goldberg said.

Drawing attention to the inherent limits of economists' knowledge, the authors introduce a new approach to economic analysis: Imperfect Knowledge Economics (IKE). IKE rejects exact quantitative predictions of individual decisions and market outcomes in favor of mathematical models that generate only qualitative predictions of economic change. Using the foreign exchange market as a testing ground for IKE, the book sheds new light on exchange-rate and risk-premium movements, which have confounded conventional models for decades. Once one abandons the mechanistic models of contemporary economics in favor of IKE models, one begins to see that macroeconomic fundamentals do matter for exchange rate movements, but in ways that cannot be fully foreseen.

Edmund Phelps, winner of the 2006 Nobel Prize in economics, calls the book marvelous and says it offers "invaluable insights of the 'early modern' theory of capitalism that were lost when the profession endorsed rational expectations equilibrium. Happily for me and, I believe, for the profession of economics, this deeply original and important book gives signs of bringing us back on track -- on a road toward an economics possessing a genuine microfoundation and at the same time a capacity to illuminate some of the many aspects of the modern economy that the rational expectations approach cannot by its nature explain."

Kenneth J. Arrow, Nobel Prize-winning economist, comments that “Frydman and Goldberg open new doors by a more realistic understanding of the process of forming expectations; by recognizing that universal rules are intrinsically impossible, they exhibit a more creative understanding of the recent history of foreign exchange spot and futures markets."

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