Economists Unveil New Way to View Financial Markets

Apr 12, 2010

DURHAM, N.H. – In the aftermath of the 2007-2009 financial crisis, the “rationality of the market” began to be widely referred to as a “myth.” Too many market participants were supposedly irrational – that is, they behaved inconsistently with economists’ standard of rationality.

But the alternative mathematical behavioral finance models that have gained currency since the crisis imply that the rational market has not disappeared for good. After all, these models assume that if irrational individuals could somehow be barred from influencing market outcomes – by regulatory policy or other means – rational participants would re-gain the upper hand, thereby restoring the rational market.

Now two economists offer a new way to look at financial markets that recognizes that the rational market is a myth – in the strictest sense of the word: it is a widely held but false belief. It cannot be turned into reality by any means, including regulatory policy, no matter how wise or efficacious. The reason is simple: assets’ underlying values unfold over time in non-routine ways that no one can fully foresee.

Michael Goldberg, the Roland H. O’Neal Professor of Economics at the University of New Hampshire, and Roman Frydman, professor of economics at New York University, presented their Contingent Markets Hypothesis recently in the paper “Efficient Markets: Fictions and Reality” to world economists and financial leaders at the inaugural conference of the Institute for New Economic Thinking, King’s College, Cambridge, United Kingdom, held April 8-11, 2010.

The Contingent Markets Hypothesis acknowledges that the process driving asset prices and fundamental factors undergoes change at times and in ways that cannot be fully specified in advance. Consequently, this process cannot be adequately characterized by an overarching model.

Goldberg and Frydman point out that “by sharp contrast, contemporary economics imagines a world where all change is mechanical and putatively ‘rational’ individuals have given up searching for new ways to understand the past and future.” As such, the very notion of rational markets lacks any connection to what real world markets and their participants actually do.

“However, acknowledging that the process driving asset prices and fundamental factors undergoes non-routine change suggests that asset price swings are not the product of irrational behavior but play an indispenable role in guiding society to allocate capital to alternative projects and companies,” the economist argue.

Although markets play an essential role in allocating society’s scarce capital, they are not perfect. As Goldberg and Frydman put it, “market participants, like everyone else, must cope with imperfect knowledge about how to interpret fundamental factors in forecasting future returns. This implies that price swings can sometimes become excessive. It is this possibility that provides an alternative rationale for policy intervention in asset markets. It also has important implications for how regulators should measure and manage systemic risk in the financial system.”

Goldberg and Frydman are the authors of “Imperfect Knowledge Economics: Exchange Rates and Risk,” which presents their ground-breaking research and development of the Imperfect Knowledge Economics model that asserts that exact models of purposeful human behavior are beyond the reach of economic analysis. Goldberg and Frydman 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.
The University of New Hampshire, founded in 1866, is a world-class public research university with the feel of a New England liberal arts college. A land, sea, and space-grant university, UNH is the state's flagship public institution, enrolling more than 12,200 undergraduate and 2,200 graduate students.

Editors and Reporters: If you would like a copy of the research article “Efficient Markets: Fiction and Reality,” contact Lori Wright at lori.wright@unh.edu.