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# UNH Professor: Current Economic Theory Made Global Financial Crisis Virtually Inevitable New Book Gives Reasons Why Economists' Ideas Are So Often Flawed

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DURHAM, N.H. -- The global financial crisis that started in 2007 undermined ideas that have shaped economics, finance, and public debate about markets and state intervention for decades. Which economic ideas now survive and which are discarded will impact reform of financial systems and macroeconomic policymaking – and thus the future of capitalism.

In “Beyond Mechanical Markets,” (Princeton University Press, 2011) Michael Goldberg, the Roland H. O’Neal Professor at the University of New Hampshire, and colleague Roman Frydman, professor of economics at New York University, offer a fresh, nontechnical appraisal of the reasons why economists’ ideas are so often flawed and how contemporary macroeconomic and finance theory made the crisis more likely, if not inevitable.

“Huge excesses in asset prices and leverage ratios had built up in the financial system in the run-up to the crisis. But conventional economic theory led Federal Reserve chairmen Alan Greenspan and Ben Bernanke and other key regulators to believe that markets were nearly perfect and that they need not even look for excess in the system; they thought they could be asleep at the wheel. Had they been on guard and acted to dampen the excesses when they arose, the crisis would have been less severe or perhaps been avoided all together,” Goldberg says.

Well before the crisis struck, the authors warned of the fatal flaw in contemporary economics: the presumption that market outcomes can be explained as if the future followed mechanically from the past. Puzzlingly, the underlying belief that nothing genuinely new ever happens – that any change and its consequences can be fully foreseen – has survived even the crisis.

In their new book, Goldberg and Frydman show how the failure to abandon this assumption hinders our understanding of how markets work, why price swings help allocate capital to worthy companies, and what role the state can and cannot play. Building on their path-breaking book “Imperfect Knowledge Economics”(2007), Goldberg and Frydman show that once we acknowledge that nonroutine change is the hallmark of capitalist economies, we can understand much better how asset prices – and the risks associated with trading in financial markets – move over time.

According to the authors, the reason that financial markets are essential to a modern economy – because they are the best institution to deal with nonroutine change – also makes them imperfect assessors of asset values. The recurrence of excessive asset-price fluctuations, which ultimately inflict great costs on the financial system and the real economy, is evidence that financial markets sometimes grossly *misallocate* capital.

Goldberg and Frydman propose a variety of prudential policy measures aimed at dampening excessive asset-price fluctuations and regulating financial institutions’ risk exposure *before* they reach crisis levels. Their conceptual framework restores balance to the public debate concerning what should be left to the markets and what only the state and collective action can accomplish.

“Beyond Mechanical Markets” has received praise from top economics worldwide.

"The economy is not just mechanical; much change is nonroutine. In turn, many important economic decisions are also nonroutine. Based on this insight, Frydman and Goldberg give us a new theory of the business cycle. In market after market, they convincingly argue its realism. What's more, 'Beyond Mechanical Markets' gives us a doctor's prescription for dampening--and possibly even avoiding

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altogether—the next economic crisis,” said George Akerlof, Nobel Laureate in economics.

"This book is a milestone. It breaks important new ground in the refoundation that macroeconomics and finance so badly need. The authors' rereading of Keynes will come as a revelation to behavioralists and Keynesians," said Edmund Phelps, Nobel Laureate in Economics.

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#### **PHOTO**

Michael Goldberg, the Roland H. O'Neal Professor at the University of New Hampshire.

[http://www.unh.edu/news/img/michael\\_goldberg\\_UNH.jpg](http://www.unh.edu/news/img/michael_goldberg_UNH.jpg)

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*Editors and Reporters: Review copies of "Beyond Mechanical Markets" may be obtained from Andrew DeSio, director of publicity, Princeton University Press, (609) 258-5165 and [Andrew\\_DeSio@press.princeton.edu](mailto:Andrew_DeSio@press.princeton.edu).*

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