Financial Economics: The Discipline
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I. Areas in the discipline affected by the recent economic events (financial crisis followed by a recession)
   1. The Rational Expectation Hypothesis: Individuals act rationally and human behavior can be packaged into equations and models.
   2. The Efficient Market Hypothesis: Markets are efficient and share prices reflect their true value
   3. The use of generalization: The economic “everyman” used to explain the macro economy.

II. Markets do not always work towards stability or equilibrium
   1. Investors are not always rational (buying when prices are low, selling when prices are high)
   2. Prices do not always reflect true value: Bubbles create sudden panic which leads to crises. Two papers I published on the effects of panic (or irrational behavior) on financial crises can be found at:
   3. Idealism pushes economists to argue for Free Markets: Assuming that individuals know what they are doing and act rationally; their actions will lead to market stability. The reality is sometimes different (but not always). Some oversight and regulation is needed.
   4. Adam Smith or John Maynard Keynes?

III. Conclusion
Not much was changed in the way the discipline is taught. The theories still apply as long as the assumptions are clearly understood, and serve as the basis for more complex and complete models. However, humility in the profession is needed. Economists should recognize their limited ability to make perfect predictions for a simple reason: Human decisions and behavior cannot always be predicted. Economics is not a hard science, it is a social science. While the use of mathematical models is helpful, the models should be used with care and intuition, and should reflect different scenarios and changes in the variables at hand. A “one size fits all model” is simply not applicable. While we can certainly learn from the past, and all economic crises have elements in common, each one has at least one new variable never faced before.

IV. Major problems that led to the crisis and that are still critical and unresolved:
   1. Risk: The difficulty of risk assessment and the continuous focus by CEOs on short term instead of long term gains
   2. Debt and Leverage: The continuous reliance on debt and increasing returns through financial leverage. While leverage works wonders when it magnifies gains in periods of prosperity as asset prices go up, it works the other way around and magnifies losses as soon as markets collapse and asset prices go down.
   3. Distribution of Income: The increasing gap between rich and poor is an additional reason believed to have contributed to the financial and economic crisis.