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"How Did Economists Get It So Wrong?" by Paul Krugman

1. Macroeconomists were convinced by idealistic mathematical models that the financial markets were inherently stable and that the Federal Reserve was capable of preventing all economic downturns. Numerous economists, including the former Federal Reserve Chairman Ben Bernanke, contended that the Great Moderation – the name given to a period of decreased macroeconomic volatility and increased stability that had persisted for over two decades – was clear evidence of the efficacy of improvements in the Fed's economic policies. Economists in general had come to neglect the irrationality of individuals and the imperfect nature of the market system, and thus did not address the problems of the housing bubble or subprime lending.
2. Following the Great Depression, as some economists lost faith in the presumptions of neoclassical economics, Keynes began to criticize the notion that free-market economies were self-correcting, and stated that financial markets were dominated by speculation and irrationality. He advocated that in order to fix capitalism and resolve economic downturns, the government should actively intervene and implement expansionary fiscal policy, increasing the money supply and spending money on public works in order to decrease the unemployment rate.

3. Criticizing Keynes' theory, the neo-classicist Milton Friedman stated that the government's role should be solely to maintain and stabilize the nation's money supply. As a proponent of the doctrine of monetarism, Friedman believed that government intervention should be limited to the instruction of central banks to steadily increase the money supply and thus engender steady economic growth. The monetarists believed that any further expansionary policies would lead to high inflation and unemployment.
4. The efficient market theory, developed by Eugene Fama of the University of Chicago, states that the prices of assets in financial markets always reflect all publicly available information. Essentially, the theory states that the price of an asset always reflects its intrinsic worth. The theory assumes that all economic actors are wholly rational, and that the financial markets are always right.
5. The freshwater economists, named for their association with schools around the Great Lakes such as the University of Chicago, are neoclassical purists who believe that Keynesian economics is incorrect and that economic analysis must be done with the presumption that people are rational. They contend that recessions are not demand driven and cannot be solved by government intervention. Furthermore, they contend that recessions may be good for the economy rather than bad. According to the freshwater economist Edward Prescott of the University of Minnesota, unemployment is the result of a rational and voluntary reduction in work effort when conditions are unfavorable.
6. The saltwater economists, primarily associated with coastal universities, have a largely Keynesian view of recessions. They believe that changes in demand have

a great impact on the business cycle, and reject the neoclassicists' assumption of perfect markets and rationality. Saltwater economists do not believe that fiscal policy is necessary in order to fight recessions, and believe that the monetary policy of the Federal Reserve is sufficient.

7. Krugman writes that neoclassicists such as Alan Greenspan were perhaps unable to see the housing and financial bubbles due to their belief that bubbles simply do not happen. As the developer of the efficient-market theory Eugene Fama explained, the neoclassicists trusted housing markets because they believed that since prices of houses were carefully compared, the prices were justified and correct. And since they believed that the Fed had everything under control, they were unable to foresee the housing bubble.
8. Neoclassical monetary policy was unable to fight the current downturn. The Federal Reserve could not stimulate economic growth and end the current recession by lowering interest rates due to the existence of the "zero lower bound", which essentially means that the efficacy of conventional monetary policy decreases as the interest rate approaches zero.
9. Behavioral finance explains the irrationality of investors as the result of inherent biases in human cognition, and emphasizes the limitations of rationality in general. Behavioralists think that people are prone to herd behavior and that markets are likewise governed by moments of irrational exuberance and panic. The behavioralists seek to acknowledge the flaws and inefficiencies of the market system in order to reform and gain a more realistic understanding of macroeconomics and finance.

Works Cited

Krugman, Paul. "How Did Economists Get It So Wrong?" *The New York Times*. The New York Times, 06 Sept. 2009. Web. 14 Mar. 2016.