A watershed moment in economics and finance

Recession, crisis spark new directions for scholarship

Stephanie Schorow, MIT News Office
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A year ago, MIT economics graduate student Alp Simsek was suffering from low spirits and burnout as he struggled to determine his PhD thesis topic. He wanted a meaningful research project that explained something important about real-world economics, but he couldn't seem to develop an innovative research framework. Then the economic crisis hit, and Simsek saw significant new avenues for scholarship opening up. His energy returned.

Simsek's experience -- or something akin to it -- is not unique among the faculty and students in MIT's Department of Economics and the MIT Sloan School of Management. While acknowledging the public pain of the credit crunch, mortgage crisis and banking failures, many acknowledge that it's an exciting time to study economics. The prolonged recession has opened up new areas for research and encouraged innovative approaches to teaching economics.

"This is intellectually fascinating for many of us," says Ricardo Caballero, head of the Department of Economics and the Ford International Professor of Economics, describing the market shocks and subsequent policy moves of the past six months. "My financial wealth has declined, but my human wealth has increased."

The recession may be prompting more people to seek graduate degrees in economics or MBAs. Applications to Sloan last fall rose 28 percent from the previous year, while the Department of Economics saw a more than 10 percent increase in graduate applications last fall and expects applications to jump again this year.

Moreover, the urgent questions now squarely facing economists are affecting how economics is taught, says Kristin J. Forbes, associate professor of international management at Sloan.

"For example, I started a new class, 'Global Economic Challenges,' this year that was initially going to focus on longer-term challenges for the global economy such as aging populations, global warming, the rise of emerging markets, and oil and commodity markets," Forbes says. "As the crisis started to unwind last year, I adjusted the course so that this winter we spent about half the course studying financial crises -- the causes, solutions, consequences and ways to predict and avoid them. Students were very interested in the course and it provided the tools to help evaluate the current global crisis."

Simon Johnson, the Ronald A. Kurtz Professor of Entrepreneurship at Sloan, structured a fall semester class around "The Baseline Scenario,"

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an economics blog he had launched with James Kwak, a consultant and Yale Law School student. The only assigned reading for the class was the blog, which tracked the deepening financial crisis. "People from outside MIT could post questions that we would then take up in our classes, which were webcast so that anyone in the world could watch," Johnson says. The result was a spirited and informative dialogue available to both students and a public becoming increasing aware of economic issues, he says.

"Economists recognize how painful and wrenching the experiences of an economic downturn like the one we are currently experiencing can be for households and firms, but they also find that times like this create a lot of new research questions," says James M. Poterba, the Mitsui Professor of Economics and president of the National Bureau of Economic Research.

Many of those research questions are related to the banking sector, because recent events have challenged conventional wisdom about the operation of banks, Poterba says.

"Ever since the end of World War II, the opinion got spread around that the financial system had learned to protect itself against the risk of instability. I think what we've now learned is that we haven't yet succeeded in doing that," says Robert Solow, Department of Economics professor emeritus.

Economics graduate student Jennifer La'O is among those examining the new pressures facing banks. For her thesis, she is analyzing how predatory trading -- trading that exploits the need of other investors to reduce their asset positions -- may make it almost impossible for large banks to raise capital in times of financial distress. This may explain why, for example, now-bankrupt Lehman Brothers waited so long to look for extra capital, she says.

Today, ailing banks that are actually solvent or could be saved may fail because of predatory behavior, says La'O, whose interest in this area was triggered by the collapse of Bear Stearns in March 2008. "It is still too early to say how much predatory trading has contributed to the current financial crisis," she says. "I do, however, feel that this type of strategic behavior is likely playing a large role in exacerbating the current crisis."

Caballero said at least seven economics faculty and graduate students, including Simsek, are pursuing research topics inspired, in part, by current events.

Before the financial crisis hit, Simsek had been considering a thesis on the effect of entrepreneurship on economic growth. "Then came the economic crisis and brought with it new issues which could be studied using the economic methodology," he says. Among the questions he asked in the wake of last year's chaos on Wall Street was whether new financial instruments such as sub-prime mortgage-backed securities and their derivatives -- assets created ostensibly as a way to decrease market risk -- had actually increased risk.

"An economic model reveals that these instruments may lead to so much speculative betting that they may actually increase the risk in financial markets," he says. "It's like Wall Street goes to Vegas."

77 massachusetts avenue
cambridge, ma 02139-4307
617-253-2700
newsoffice@mit.edu