dignified end.

Seven years ago, when Dietrich and her husband moved into a house in Asheville, North Carolina, that had a flag holder on the deck, her husband suggested getting a flag. "What would the neighbors think?" Dietrich wondered. In the post–9/11 era, "was it possible anymore to fly a flag and have it mean merely that, no other messages involved?"

If you pass by Dietrich's house today, you'll likely find one there—her third—on sunny days and national holidays, on September 11 and on Flag Day, "if we remember it." Dietrich and her husband "know the rules. We are careful and respectful of our flag. We don't put it out in the rain. We bring it in at night. We never let it touch the ground."

ECONOMICS, LABOR & BUSINESS

Blind-Sided

THE SOURCE: "How Did Economists Get It So Wrong?" by Paul Krugman, in ***The New York Times Magazine***, Sept. 6, 2009.

Why did so many economists fail to anticipate the economic crisis of 2008? Their heads were turned by beautiful, intellectually elegant mathematical models of the economy that told them such a thing couldn't happen, writes Paul Krugman, a *New York Times* columnist and Nobel Prize–winning economist at Princeton.

For decades after the Great Depression, economic thought was dominated by the ideas of John Maynard Keynes, who argued that market economies, and especially financial markets, were apt to malfunction, and therefore needed a significant dose of government oversight. In 1953 the University of Chicago's Milton Friedman struck back, launching what came to be known as the "neoclassical" model. People and markets were essentially rational, he tried to show. He saw a role for government in keeping the economy on track, but it was limited largely to stewardship by the Federal Reserve (whose bumbling he blamed for the Great Depression). Friedman's heirs pushed things further. By about 1970, economists generally accepted the "efficient-market hypothesis" of his Chicago colleague, Eugene Fama, with its assertion, as Krugman puts it, that "financial markets price assets precisely at their intrinsic worth given all publicly available information." In other words, markets and the people who make them are perfectly rational, all the time.

EXCERPT

Double Bubble

A few years ago Karl Case and I asked random home buyers in U.S. cities undergoing bubbles how much they [thought] *the price of their home* [would] *rise each year on average over the next 10 years. The median answer was sometimes 10 percent a year. If one compounds that rate over 10 years, they were expecting an increase of a factor of 2.5, and, if one extrapolates, a 2,000-fold increase over the course of a lifetime. Home prices cannot have shown such increases over long time periods, for then no one could afford a home.*

The sobering truth is that the current world economic crisis was substantially caused by the collapse of speculative bubbles in real estate (and stock) markets—bubbles that were made possible by widespread misunderstandings of the factors influencing prices. These misunderstandings have not been corrected, which means that the same kinds of speculative dislocations could recur.

—**ROBERT J. SHILLER**, a Yale economist and cocreator of the widely used Case-Shiller Home Price Indices, in ***The Economists' Voice*** (Issue 7, 2009)

It wasn't as crazy as it sounds. Several other beautiful theories flowed from Fama's idea, and on paper—or in elaborate computer models—they were backed by plenty of evidence. They also spawned more than a few Nobel Prizes and Wall Street fortunes. The problem, as Harvard economist (and now top Obama administration economic adviser) Larry Summers once said, was that they all amounted to "ketchup economics": You can show very elegantly that the market will efficiently price two-quart bottles of ketchup at twice the price of a one-quart bottle; the problem is that the one-quart bottle may be mispriced.

Summers is a New Keynesian economist, one of a group that has held to Keynes's essential point that market malfunctions can cause economic downturns. Investors may get caught up in panics; large numbers of people may stop spending money even though there appears to be no objective reason for them to do so. But, lulled by the solid economic performance of 1985–2007, the New Keynesians tended to agree with the neoclassicists that the economy normally functions smoothly and that smart Federal Reserve policy is sufficient to keep it on track. Meanwhile, neoclassicists pushed into more extreme ground. In the 1980s, Edward Prescott of the University of Minnesota, later a Nobel Prize winner, argued that changes in demand were not caused by the business cycle at all but by outside forces, such as technological change. Bubbles, some of the neoclassicist economists argued, just couldn't happen. All the theories proved it.

What now? Keynesianism is not dead—it inspired the Obama administration's massive stimulus package—but the New Keynesians' elaborate models (including Krugman's own, he confesses) can't cope with the kind of upheaval the financial sector and the larger economy have experienced. Economists of all kinds counted on the Federal Reserve as the ultimate steward of the economy, but it has cut interest rates virtually to zero and has no ammunition left. Economists will need to recognize that the economy is a lot messier than they thought, Krugman argues. There are plenty of building-blocks for new models—Fed chairman Ben Bernanke contributed an important piece in his time as a Princeton economist—but, Krugman says, "it will be a long time, if ever, before the new, more realistic approaches . . . offer the same kind of clarity, completeness, and sheer beauty" that once bedazzled so many.

ECONOMICS, LABOR & BUSINESS

The Cost of 9/11

THE SOURCE: "The Economic Impacts of the September 11, 2001, Terrorist Attacks" edited by S. Brock Blomberg and Adam Z. Rose, in ***Peace Economics, Peace Science, and Public Policy***, Vol. 15, No. 2, 2009.

How many people died as a result of the terrorist attacks of September 11, 2001? Most sources now settle on the figure of 2,975, but too many imponderables confound a perfect determination. For example, do you count the man who died later of lung cancer after breathing debris from New York's ruined World Trade Center?

How much harder it is to tally the economic impact of 9/11. The online journal *Peace Economics, Peace Science, and Public Policy* put the question to eight research teams and individuals. They were told to leave aside the cost of remedial action at the World Trade Center site, heightened homeland security that has left government and industry buildings ringed with bollards and patrolled by armed guards, and military actions overseas. Nonetheless, some of the findings are surprising.

Nearly all the researchers came back with results that pegged the cost to the national economy (in 2006 dollars) at between $35 billion and $109 billion—about 0.5 percent to 1 percent of GDP. That is much less than some earlier estimates, which ranged as high as $500 billion.

A team headed by economist Adam Z. Rose of the University of Southern California found that losses from business interruptions totaled "only slightly over $100 billion." The Rose team arrived at its figure by looking individually at the affected business sectors for three years after the attacks occurred. By its estimates, air transportation suffered the biggest hit—$35 billion in losses over two years—followed by hotels ($22 billion) and restaurants ($14 billion).

Rose and his group also looked more narrowly at the impact on firms housed in the World Trade Center and other damaged or destroyed buildings nearby. Of the 1,134 firms em-