# There Is No Invisible Hand
# By Joseph Stiglitz
# The Guardian
# December 20, 2002

Three cheers for the latest Nobel laureates in economics: Daniel Kahneman of Princeton University, and Vernon Smith of George Mason University in Virginia. Like many Nobel prizes, these awards recognise not only the seminal work undertaken by Kahneman and Smith, but also the schools of thought they help to lead.

Kahneman, a psychologist, has demonstrated how individuals systematically behave in ways less rational than orthodox economists believe they do. His research shows not only that individuals sometimes act differently than standard economic theories predict, but that they do so regularly, systematically, and in ways that can be understood and interpreted through alternative hypotheses, competing with those utilised by orthodox economists.

To most market participants - and, indeed, ordinary observers - this does not seem like big news. Wall Street brokers who peddled stocks they knew to be garbage exploited the irrationality that Kahneman and Smith exposed. Much of the mania that led to the bubble economy was based on exploiting investor psychology.

In fact, this irrationality is no news to the economics profession either. John Maynard Keynes long ago described the stock market as based not on rational individuals struggling to uncover market fundamentals, but as a beauty contest in which the winner is the one who guesses best what the judges will say.

This year's Nobel Prize celebrates a critique of simplistic market economics, just as last year's award (of which I was one of the three winners) did. Last year's laureates emphasised that different market participants have different (and imperfect) information, and these asymmetries in information have a profound impact on how an economy functions.

In particular, last year's laureates implied that markets were not, in general, efficient; that there was an important role for government to play. Adam Smith's invisible hand - the idea that free markets lead to efficiency as if guided by unseen forces - is invisible, at least in part, because it is not there.

This, too, is not news to those who work day after day in the market (and make their fortunes by taking advantage of and overcoming asymmetries in information). For more than 20 years, economists were enthralled by so-called "rational expectations" models which assumed that all participants have the same (if not perfect) information and act perfectly rationally, that markets are perfectly efficient, that unemployment never exists (except when caused by greedy unions or government minimum wages), and where there is never any credit rationing.

That such models prevailed, especially in America's graduate schools, despite evidence to the contrary, bears testimony to a triumph of ideology over science. Unfortunately, students of these graduate programmes now act as policymakers in many countries, and are trying to implement programmes based on the ideas that have come to be called market fundamentalism.

Let me be clear: the rational expectations models made an important contribution to economics; the rigour which its supporters imposed on economic thinking helped expose the weaknesses underlying many hypotheses. Good science recognises its limitations, but the prophets of rational expectations have usually shown no such modesty.

Vernon Smith is a leader in the development of experimental economics, the idea that one could test many economic propositions in laboratory settings. One reason that economics is such a difficult subject, and why there are so many disagreements among economists, is that economists cannot conduct controlled experiments. Nature throws up natural experiments, but in most circumstances, so many things change so rapidly that it is often difficult to untangle what caused what.

In principle, in a laboratory, we can conduct controlled experiments, and therefore make more reliable inferences. Critics of experimental economics worry that subjects bring to experimental situations modes of thought determined outside of the experiment, and thus that the experiments are not as clean and the inferences not as clear cut as in the physical sciences. Nonetheless, economic experiments provide insights into a number of important issues, such as the improved design of auctions. Most importantly, the irrationality of market participants, which was the focus of Kahneman's work, has been verified repeatedly in laboratory contexts.

Among the more amusing results that have come out of experimental economics are those concerning altruism and selfishness. It appears (at least in experimental situations) that experimental subjects are not as selfish as economists have hypothesised, except for one group - the economists themselves.

Is it because economics as a discipline attracts individuals who are, by nature, more selfish, or is it because economics helps shape individuals, making them more selfish? The answer, almost certainly, is a little bit of both. Presumably, future experimental research will help resolve the question of the relative importance of these two hypotheses.

The Nobel Prize signifies how important it is to study people and economies as they are, not as we want them to be. Only by understanding better actual human behaviour can we hope to design policies that will make our economies work better as well.