8-12-2009

The Myth of the Rational Market: Nudging Each Other Away from Fool's Gold

Gary D. Lynne
University of Nebraska-Lincoln

CORNHUSKER ECONOMICS

University of Nebraska–Lincoln Extension

August 12, 2009

Institute of Agriculture & Natural Resources
Department of Agricultural Economics
http://www.agecon.unl.edu/Cornhuskereconomics.html

The Myth of the Rational Market: Nudging Each Other Away from Fool's Gold

Market Report	Yr Ago	4 Wks Ago	8/7/09
Livestock and Products, Weekly Average			
Nebraska Slaughter Steers, 35-65% Choice, Live Weight.	$99.66	$81.61	$81.14
Nebraska Feeder Steers, Med. & Large Frame, 550-600 lb..	130.01	116.75	120.38
Nebraska Feeder Steers, Med. & Large Frame 750-800 lb.	117.91	105.22	104.99
Choice Boxed Beef, 600-750 lb. Carcass.	160.94	137.81	141.49
Western Corn Belt Base Hog Price Carcass, Negotiated.	87.42	57.76	48.38
Feeder Pigs, National Direct 50 lbs, FOB.	49.00	39.62	*
Pork Carcass Cutout, 185 lb. Carcass, 51-52% Lean..	90.56	56.12	56.62
Slaughter Lambs, Ch. & Pr., Heavy, Wooled, South Dakota, Direct..	103.37	103.00	96.50
National Carcass Lamb Cutout, FOB.	278.01	257.01	253.52
Crops, Daily Spot Prices			
Wheat, No. 1, H.W. Imperial, bu..	7.11	4.52	4.25
Corn, No. 2, Yellow Omaha, bu.	4.72	3.04	3.01
Soybeans, No. 1, Yellow Omaha, bu.	11.72	10.35	11.54
Grain Sorghum, No. 2, Yellow Dorchester, cwt..	7.16	5.02	5.12
Oats, No. 2, Heavy Minneapolis, MN , bu.	*	2.15	2.09
Feed			
Alfalfa, Large Square Bales, Good to Premium, RFV 160-185 Northeast Nebraska, ton..	190.00	*	*
Alfalfa, Large Rounds, Good Platte Valley, ton..	77.50	*	*
Grass Hay, Large Rounds, Premium Nebraska, ton..	85.00	*	*
Dried Distillers Grains, 10% Moisture, Nebraska Average.	162.50	97.50	85.00
Wet Distillers Grains, 65-70% Moisture, Nebraska Average.	64.00	39.50	32.25
***No Market**			

A flurry of media commentary and several new books are focused on the recent financial crisis and near economic collapse. A *Newsweek* article by Zakaria (2009), "Greed is Good (To a Point)," suggests reconsidering the role of greed in capitalism. This is also the theme in *Fools Gold (*Tett, 2009), a story about the way derivatives markets have evolved: showing greed at its worst. In many ways this is the core source of the current set of problems. In some sense, these perspectives are integrated in *The Myth of the Rational Market* by Fox (2009), who traces the thinking on the efficient market hypothesis, now understood for what it is: a myth. Both books are based in large part on interviews with major players in the crisis. There are also books drawing mainly on science, but still quite accessible to general readers, as represented in *Nudge* by Thaler and Sunstein (2008). Both have done extensive research on human foibles in economic choice. There is also *Animal Spirits* (Akerlof and Schiller, 2009), a book about what Keynesian economics is really about, a look at human forces at work. Akerlof is a Nobel prize winner in economics, who before this has pointed to the problems with presuming rationality in real markets. Schiller is one of the few economists who predicted these events.

The story starts with a group of traders within J.P. Morgan who set out in the early 1990s to enhance the efficiency of credit markets: derivatives would become the answer. One of the first credit derivative trades arose (Tett, 2009, pp. 46-47) from Exxon's request for a $4.8 billion credit line in case they would have to pay upwards of $5 billion in fines due to the Valdez oil tanker spill. J.P. Morgan wanted to oblige this old customer; there was commitment and loyalty at stake. Yet this would require a large capital reserve, and would not produce much profit. Exxon was a low risk borrower, and rates would be modest. J.P. Morgan was aware that the European Bank for Reconstruction and Development (EBRD) had a large amount of credit available to extend to companies, but was restrained from making high risk loans so was looking for higher returns. J. P. Morgan saw a potential opportunity, in effect selling the risk to EBRD and freeing capital reserves, with a win-win for everyone… economic efficiency at work. Exxon got a credit line, J.P. Morgan demonstrated commitment to a customer while reducing credit reserves, and EBRD gained increased returns while buying the (low) risk. Derivatives markets on credit lines were born, based on the efficient market hypothesis, which is oblivious to community and social context.

This hypothesis has been considered a landmark in 20th century economic thinking (Fox, 2009, p. 43). The fact that market prices cannot with any high degree of accuracy be forecasted, suggests that the market knows best, being perfectly efficient. This became the mantra of the "Chicago (Economics) School," with said market to be unfettered, not nudged. Milton Friedman, a prominent member of this school, argues that assumptions underlying economic theories, no matter how unrealistic, (e.g. greed-is-good) did not matter (Fox, 2009, p. 76). This is an argument which generations of economists bought. All that mattered was how well the theory predicted. The efficient market hypothesis seemed to do this, so that everyone in the markets somehow knew, together, the best direction for prices as though guided by an invisible hand. Magically, the market would regulate itself.

So what went wrong? Well, it is really very simple. The efficient market hypothesis is a myth, because it is premised on perfectly rational humans, which we are not. Instead, we are prone to intemperance (especially greed), overconfidence, running-on-automatic with little cognitive and rational consideration, less than perfect self-control and are especially prone to herd-like behavior. These kinds of behaviors drove the overheated economies of the 1920s leading to the 1930's Great Depression, and the "irrational exuberance" (attributed to Alan Greenspan, see Fox, 2009, p. 257) of the 1990s and early-2000s, which led to the crisis in 2008. Herd activity, especially in panics (Akerlof and Schiller, p. 64), is a prominent component of our animal spirit(s). We spread the derivatives markets into credit, interest, currency and yes, even into taking the risk out of the sub-prime home mortgage markets, or so the herd believed.

Overall, perhaps enough cannot be said about the role of tempered greed, demonstrated by the exceptions. J. P. Morgan (now JP Morgan Chase), emerged virtually unscathed due to tempered compensation schemes and commitment to customers (Tett, 2009, pp. 243-254). As Thaler and Sunstein (2008, p. 72) argue, there is a need for a "golden rule of libertarian paternalism" … nudging each other to ensure we are all helped, while minimizing individual harm. In other words, we need freedom of choice (libertarian, child-like freedom), which is occasionally nudged (paternalistic, parent-like nurturing, giving context), onto better paths. If everyone is doing it, first empathizing ... the strong version of the more traditional golden rule of envisioning-oneself-in-the-shoes-of-others and asking the empathy question: "How would I wish to be treated in that situation?"… and then nudging each other on the basis of this kind of empathy based paternalism, the markets start to work. Greed is good to a point, tempered by the shared wisdom about and the shared other-interest in what is reasonable. The myth is that we are in this alone, and that we can rely on the magic of an invisible hand to achieve efficiency. Rather, we are in this together, and through empathy and appropriate, visible nudges (and yes, some regulation when nudging fails), we move forward individually and together in sustainable ways. The right price emerges with empathy-based nudging: This is true market efficiency.

Gary Lynne, (402) 472-8281
Professor, Dept. of Agricultural Economics
University of Nebraska-Lincoln
glynne1@unl.edu

References:

Akerlof, G.A., R.J. Shiller, 2009. *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism*. Princeton University Press, Princeton, NJ.

Fox, J., 2009. *The Myth of Rational Markets: A History of Risk, Reward, and Delusion on Wall Street.* Harper Collins, New York, NY.

Tett, G., 2009. *Fool's Gold: How the Bold Dream at J.P. Morgan Was Corrupted by Wall Street Greed and Unleashed a Catastrophe*. Free Press, New York, NY.

Thaler, R.H., C.R Sunstein, 2008. *Nudge: Improving Decisions About Health, Wealth, and Happiness*. Yale University Press, New Haven, CT.

Zakaria, F., 2009. "Greed is Good (To a Point)." *Newsweek*, June 22, pp. 41-45.