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MINNPOST

Latest Nobel prize reflects how economics works — and what economists don't know

By [Louis D. Johnston](#) | 10/17/13



“The
Sveriges

REUTERS/Jim Young

2013 Nobel Prize winners Eugene F. Fama and Lars Hansen attending an Oct. 14 news conference.

Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2013 was awarded jointly to Eugene F. Fama, Lars Peter Hansen and Robert J. Shiller ‘for their empirical analysis of asset prices.’”

Boy, could you be any more boring than that? The Nobel committee probably would have described the Reformation as a dispute between the Vatican and a monk.

Here is my summary of the prize, awarded last week: One laureate thinks financial markets work well, another thinks not, and the third developed statistical techniques to test the competing hypotheses and concluded they are both partially true. This leaves a lot of space for spirited disputes about the nature of financial markets and for more research on this important topic.

Fama posited what has come to be called the efficient markets hypothesis. According to Fama: “An efficient market is a market that is efficient in processing information. The prices of securities at any time are based on correct evaluation of all information available at that time. In an efficient capital market, prices fully reflect available information.” Financial markets work well.



Shiller is the leading developer the field known as behavioral finance. As he told the **Washington Post**: “When I look around I see a lot of foolishness, and I can’t believe it’s not important economically.” In particular, Shiller argues that financial markets don’t work well and are prone to bubbles such as the stock market boom and bust of the late 1990s and the housing market of the 2000s. (Shiller, along with Karl Case of Wellseley College, developed the home price indices that **bear his name.**)

Hansen, who earned his Ph.D at the **University of Minnesota**, created statistical techniques that allowed economists to test the Efficient Markets Hypothesis against the data. The method, called **Generalized Method of Moments Estimation**, quickly became a standard tool in the financial economist’s toolbox.

Ok, so what? Why should you care about this? Because this prize, more than usual, reflects the way economics, in particular, and social science, in general, really works.

Roiling financial markets have been at the center of global economic problems for the past 200 years, and this was the fourth time since 1990 that the Nobel went to scholars whose primary focus was the study of financial markets. (Previous awards were in **1990**, **1997** and **2003**.) Yet this year’s prize stems from the uncomfortable truth that economists still don’t really understand how financial markets work. We’re gradually learning more about them, but we’re not there yet.

And this shouldn’t bother us because this is the way the natural sciences and engineering work too. **Henry Petroski**, professor of civil engineering at Duke University, wrote a wonderful essay on this topic entitled “Which Comes First?” He writes that the history of technology makes it clear, “engineering can proceed even in the absence of a complete and correct preexisting scientific understanding of the natural phenomenon involved.” Petroski points out, for example, that “airplanes would be flying for decades before there was a full physical and mathematical explanation of why wings worked.”

That’s where we’re at now in economics. We’ve built financial markets that allocate capital across space and time, that move billions of dollars per hour around the globe and promise returns on investments years into the future. But like airplanes, wireless telegraphy, steam engines and other examples from engineering, we don’t really know how financial markets work. Yet.

But we're getting there. And it's important that we keep plugging at it. Financial markets have been at the center of most economic downturns over the past 200 years, and we need to understand why they boom and crash just as much as we need to understand why airplanes fly.

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