

“A WIDE-RANGING, INFORMED AND
THOROUGHLY ENJOYABLE TOUR OF THE FRONTIERS OF ECONOMICS.”

—TIM HARFORD,

Financial Times columnist and author of *The Logic of Life* and *The Undercover Economist*

20 ECONOMICS

WHAT THE BEST
MINDS
IN ECONOMICS CAN
TEACH
YOU ABOUT BUSINESS AND
LIFE

NORBERT HÄRING *and* OLAF STORBECK

A CUTTING-EDGE
LOOK AT HOW
ECONOMICS AFFECTS US
IN UNEXPECTED WAYS

Economics shapes our lives, from global policy to how much you pay for a new pair of shoes made in China to whether you will survive your bypass surgery. For example, do you know how fitness studios earn most of their money?—From the laziness and irrationality of their customers. Why are women more successful investors?—Because they are more humble and less interested in finance.

Featuring recent work from top thinkers in the economics field from around the world, such as Philippe Aghion, Paul Krugman, George Akerlof, Gary Becker, and George Loewenstein, the book includes chapters on the rationality versus the irrationality of financial markets, the subprime crisis, globalization, and the methods marketers are using to sell us products we don't need.

Economics 2.0 makes an impressive case for the argument that economics is not a dry science and that economic principles are constantly exerting their influence. Completely without formulas or theoretical ballast, Norbert Häring and Olaf Storbeck present the current findings of prominent economists, helping to expand both our knowledge and our appreciation of the economics that impact and shape our lives.



ECONOMICS 2.0

WHAT THE BEST MINDS IN ECONOMICS CAN
TEACH YOU ABOUT BUSINESS AND LIFE

Norbert Häring and Olaf Storbeck

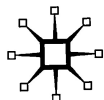
PUSTAKA PERDANA



1012331

palgrave
macmillan





ECONOMICS 2.0

Copyright © Norbert Häring, Olaf Storbeck
Translated into English by Jutta Scherer (JS textworks, Munich,
Germany), 2009.

All rights reserved.

First published in 2009 by
PALGRAVE MACMILLAN®
in the United States—a division of St. Martin's Press LLC,
175 Fifth Avenue, New York, NY 10010.

Where this book is distributed in the UK, Europe and the rest of the world,
this is by Palgrave Macmillan, a division of Macmillan Publishers Limited,
registered in England, company number 785998, of Houndmills,
Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan is the global academic imprint of the above companies
and has companies and representatives throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States,
the United Kingdom, Europe and other countries.

ISBN-13: 978-0-230-61243-3

ISBN-10: 0-230-61243-1

Library of Congress Cataloging-in-Publication Data

Häring, Norbert.

[Ökonomie 2.0. English]

Economics 2.0 : what the best minds in economics can teach you
about business and life / Norbert Häring and Olaf Storbeck ;
translated into English by Jutta Scherer.

p. cm.

Includes bibliographical references and index.

ISBN 0-230-61243-1

1. Economics—Psychological aspects. I. Storbeck, Olaf. II. Title.

HB74.5.H36 2009

330—dc22

2008031804

A catalogue record of the book is available from the British Library.

Design by Newgen Imaging Systems (P) Ltd., Chennai, India.

First edition: January 2009

10 9 8 7 6 5 4 3 2 1

Printed in the United States of America.

ISO
HAK

Contents

Preface / ix

From Dogma to Data—An Introduction by Axel Ockenfels / xi

1 Man—An Economic Animal? / 1

The Economic Split Personality / 5

When Economists Go to Kindergarten / 7

Why You Shouldn't Trust Your Children / 8

Arrival at Reality / 10

Macroeconomics in the Absence of *Homo Oeconomicus* / 13

References / 15

2 The Pursuit of Happiness / 17

That Obscure Object of Desire / 22

Master of My Fate, Captain of My Soul / 27

References / 31

3 The Enigma of the Labor Market / 33

Longer Unemployment Can Be a Good Thing / 36

Why Employers Don't Like to Cut Wages / 38

Economists in Defense of Minimum Wages / 39

Undesirable Side-Effects of Minimum Wages / 44

Fighting Unemployment in Kindergarten / 46

CONTENTS

- How Bible Studies Can Make You Rich / 49
References / 52
- 4 The Almost-Forgotten Small Difference / 55
An Economic History of Women's Emancipation / 57
Family Economics and Its Limits / 60
It Pays to Pay Women Less / 61
Women Are Less Effective Negotiators / 62
Competing against Men Is No Bed of Roses / 65
The Fear of Competition Is an Acquired Trait / 67
References / 68
- 5 It's All about Culture / 71
The Economics of Religion / 74
Culture as the True Engine of Prosperity / 75
America's Misplaced Faith in a Just World / 76
Thou Shalt Trust in the Stock Market / 78
References / 80
- 6 Economics by Scales and Measures / 81
What Causes the Leading Power to Shrink? / 82
Short People in Dire Straits / 83
Chubby People Live Longer / 84
With Elevator Shoes to Higher Income / 86
The Economics of Beauty / 88
References / 90
- 7 The Logic of Globalization / 93
How Globalization Spoils Drug Dealers' Margins / 95
Globalization According to Crustaceans / 96
Trade without Comparative Cost Advantages / 98
No Reason to Fear "Made in China" / 100
Global Competition Can Be Crippling / 102
The World—A Village? / 105
Africa's Sad Secret / 106
What Happened to All the Money? / 108
References / 109

- 8 Financial Markets—Totally Efficient or Totally Crazy? / 111
- There's No Fool Like a Stock Market Fool / 111
 - What the Eye Does Not See, the Heart Cannot Grieve Over / 113
 - The First Shall Be the Last / 115
 - Lemmings to the Sea—Many Analysts Just Follow the Crowd / 116
 - Why Analysts Speak in Two Tongues / 118
 - The Dirt on Coming Clean / 120
 - So Let Us Predict the Past / 121
 - Rational Bubbles Burst Rationally / 123
 - Of Black Swans and Black Days in the Market / 125
 - Returns on Stocks Are Lower Than You'd Think / 126
 - References / 127
- 9 Subprime Surprises—Or: The Anatomy of the Financial Crisis / 129
- What Kind of a Monster? / 130
 - How Rating Agencies Fed the Monster / 134
 - Did the Fed Egg the Monster On? / 137
 - Regulation Matters / 139
 - How Bad Will It Get? / 142
 - References / 145
- 10 Managers Are People, Too / 147
- Why Employees Run Away after Mergers / 149
 - How to Keep Cocky Managers in Check / 150
 - Why Good Managers Are Reluctant to Correct Their Own Mistakes / 152
 - Company Leaders Are Not Born That Way / 154
 - What Businesses Can Learn from Heart Surgeons / 156
 - What Bosses Can Learn from Monkeys / 158
 - Bosses, You Need to Talk More with Your People / 161
 - The Best CEOs Manage the Largest Firms / 163
 - Lots of Money, Lots of Anxiety / 165
 - References / 167
- 11 The High Art of Buying and Selling / 169
- The Winner's Curse / 169
 - Snipers Buy Cheaper / 171
 - The Illusion of a Strong Will / 173
 - Tallying Is a Matter of Luck / 175

CONTENTS

- The Customer as King—Ungrateful and Unforgiving / 177
Brand Image Pays Off Twice / 179
Join Christina Aguilera in the Winner's Circle / 181
Information Is Power / 183
References / 184
- 12 The Athlete as a Guinea Pig—Or: Why Economists Love Sports / 187
Football Teams Don't Play It Right / 188
Cricket Players Learn Very Slowly / 190
Game Theorists Playing at Wimbledon / 192
Of Incentives and Their Side Effects / 193
New Brooms Don't Sweep Any Better / 194
Slowing Down Others Will Get You There, Too / 196
When Referees Are Taking Sides / 197
References / 199
- 13 In the Dark Recesses of the Market Economy / 201
Betting on Hitler / 202
Investors, Check the Obituaries / 205
The Power of Rating Agencies / 207
Why Banks Don't Like to Google / 208
How Investment Funds Buy Good Press / 210
How a TV Station Helped George W. Bush Win the Election / 212
When Wall Street Whistles, the IMF Jumps / 214
References / 216
- 14 A Final Warning / 217
When Listening to Advice from Economists, Keep the Saltshaker Handy / 218
Soldiers of Fortune Riding the Statistics / 220
The Economics of Erring / 225
References / 228
- Acknowledgments / 229
- About the Authors / 231
- Index / 233

Preface

This book was written not only to entertain, but also to help expand the reader's horizons. Even those who have learned a proper profession should for once have a chance to see the world from the vantage point of an economist. It is an experience not unlike looking through a thermal imaging camera: Many things appear blurred and distorted, yet certain features come into view that the naked eye would never catch. And it is certainly interesting.

The book is also meant to educate. Readers studying economics, or who have done so in the past or intend to do so, will obtain an overview of the many directions the discipline has taken. Especially in recent years, economics and business studies have made huge strides. They have become more empirical, more realistic. It is this type of a contemporary economic science which we refer to as Economics Version 2.0.

Mathematical formulae and abstract graphs facilitate scientific analysis. Alas, they have limited entertainment value and so you will find none of them in this book. Those who cannot do without may read up on them in the original scientific texts this book draws from. All sources are listed. Exceptionally trustful or highly skeptical types may want to peruse the detailed pointers in the last chapter first.

—*Norbert Häring and Olaf Storbeck,*
December 2008



From Dogma to Data— An Introduction

Axel Ockenfels

Professor of Economics, University of Cologne, Germany

“How many economists does it take to change a light bulb? Answer: not a single one. If a new light bulb was needed, the market would have taken care of it.” These kinds of hackneyed jokes about economists come by the dozen. The spectrum reaches from one-liners (“Economists predicted nine out of the last five recessions”) to intellectually glib aphorisms (“Economics is the only discipline where two scientists are awarded the Nobel Prize because they came to diametrically opposite conclusions”). Yet all these jokes shine a spotlight on the public perception of what economics really stands for. Economists are frequently depicted as removed from reality and vague by design, enamored with the market as they obsess about models and charts. Criticism of economics is as old as the discipline itself. As early as the nineteenth century, Thomas Carlyle described the profession as “the dismal science,” a characterization that has stuck to this day. Economists, as the saying goes, know the price of everything and the value of nothing. Scientists from outside of the profession even accuse our profession of “imperialism,” because as economists, we are wont to stick our noses into matters supposedly alien to us, from family life and happiness



to health. In the past, such criticism may have been partially deserved. Over the last two decades, though, economics has undergone an exciting shift: the profession has moved closer to people and their problems. With increasing frequency, the oft-decried gap between science and “real life” is being bridged. Data instead of dogma is the common denominator for modern economics. The engine for such development was the discovery and use of two new scientific methods: game theory and its empirical counterpart, experimental economics. Both fields of research have jointly revolutionized economics and its exponents’ view of human behavior. Concurrently, they furnished means to economists that enabled them, not unlike design engineers, to build more effective institutions and arrive at better decisions. Game theory is a mathematically rigorous tool for analysis of a given strategic interaction. Prior to its “invention” around the middle of the last century by John von Neumann, Oscar Morgenstern, and John F. Nash, economic theory had traditionally assumed that there were so many players active in a marketplace that the response of each of them to another’s actions was essentially negligible to that other player. This may be an acceptable simplification for the purchase of, say, a carton of milk in the supermarket; however, when it comes to labor and environmental negotiations, the regulating of infrastructural markets, or oligopolistic competition and other forms of conflict and cooperation, such models are obviously of very little help. Game theory frees us of such methodological constraints. It affords us the analysis of economic, social and political interaction inside and outside of markets by use of transparent methods. It lets us detect interdependencies of economic and social behavior and helps us better understand the influence market rules and the rules governing other types of interaction have on decision making.

Game theory proves to be a highly effective advisor where incentives and behavioral strategies are concerned. Nevertheless,

it has its limits. Players populating the virtual worlds of game theory generally act without any cultural or social backdrop, but with unlimited capacity for computation. While such simplistic assumptions may be useful at times, they can easily lead to conclusions that are fundamentally wrong. One example may illustrate this point: From the angle of game theory, chess is a totally boring game. Since there are no uncertainties about the opponent's strategic options, and all moves can be exactly observed and verified, a perfectly rational player knows precisely how the opponent will react to any possible move. In other words, both players know before the first move how the game will unfold and what its outcome will be. Using game-theoretical methods, it is fairly easy to prove that the victorious side is determined prior to the first move, assuming rational behavior on both parts. On the other hand, it is equally certain that no mathematical capability of either man or machine would be enough to play chess rationally. So, how do individuals act in complex situations?

The second novelty, experimental economic research, rang in a new era for economics science. As early as in the late 1950s, economists began testing economic phenomena in laboratory experiments. The leading pioneers at the time were the later Nobel laureates in economics, Vernon Smith and Reinhard Selten. Yet decades would pass before the new methods became widely accepted. The preconception that experiments are impracticable in economic research was thoroughly entrenched in experts' minds. Today, experimental economics research is one of the most successful sectors within the science of economics. Hardly any faculty worth its salt can afford to do without a test lab.

Experimental economic research can be considered complementary to game theory, in that it concerns itself with the behavior of flesh-and-blood humans. And—lo and behold!—humans will act totally differently from what traditional economics asserts.

Fairness in negotiations, for instance, can be a great motivator and play an important role; cognitive constraints will induce systematic errors in financial market dealings, and past experiences may well skew future behavior. (This book is a goldmine for anyone wishing to delve deeper into those phenomena.)

The systematic investigation of such phenomena in tightly controlled, experimental environments reveals that individuals do not act irrationally or even chaotically. Flesh-and-blood humans hew to their own rationales. This may not always be in agreement with those of the “homo oeconomicus,” but they behave in a generally systematic and predictable fashion that can be described by economic models. This fact enables economists to leave well-trodden paths behind and develop new, descriptively relevant theories of behavior. Some of them turned out to be surprisingly robust and empirically productive. They represent the foundation of a new kind of economics we call “behavioral economics.”

The renewed vigor that game theory and experimental economics has brought to the science is further enhanced by exciting developments in related fields. Psychology, in particular, has greatly enriched economics over the past decades. It is for good reason that Daniel Kahneman became the first psychologist to receive the Nobel Prize in economics for his Prospect Theory, developed in collaboration with Amos Tversky, as it provided the basis for the emergence and popularity of the discipline of “behavioral finance.” Lately, economists have been attempting to pry even deeper into the workings of the mind, as it were. Neuro-economics combines the methods of neuroscience with those of economics. It especially seeks to identify and understand processes taking place inside the brain that go hand-in-hand with the formation of perceptions and decisions.

Innovations in mathematical methods are another factor that, over the past two decades, contributed to the advancement of the science of economics. Economic theory and statistics continue

to develop ever more refined and complex models and methods of analysis. Concomitant with it, economics has profited from technological progress. Computing power has exploded since 1980. With the press of a button, simple personal computers are able to perform complex arithmetical operations, which would have required entire computer farms two decades ago, and a tremendous amount of money and time.

An increasing reliance on mathematics, though, is not universally welcomed, even within the profession. The American economist Alan Blinder speaks of a mathematics race and complains about economics having become more math-dependent than physics. Indeed, there has been a time when our profession was in thrall to mathematics. This time is over now—at least as far as applied economics are concerned. Though modern economics cannot function without mathematics, today its methods are in thrall to us, helping us get a better grip on the economic problems of real life. How should the electric-power market be structured to achieve optimal efficiency? What tools of economic policy can help solve the unemployment problem? What are the effects of a minimum wage policy? How do cooperation, trust, and competition interact in anonymous online markets? Which incentive systems motivate people, which might have the opposite effect? How should places at day care centers or organs for transplantation be allocated? How should UMTS frequency blocks be auctioned off?

Modern economics seeks to answer these and similar questions. Rather than continuing to derive answers from its fount of eternal truths, it now employs a variety of methods and a clear focus in developing and verifying its theories. Modern economists are no longer content with just having an understanding of the markets—they are eager to use their expertise to actually improve them. Based on the latest advances in terms of methods and substance, it is becoming increasingly feasible indeed to dissect and control behavior and institutions. Innovative testing technologies

allow for a seamless transition from lab studies to the field. Even highly complex, genuine markets such as the electricity market or electronic auctions, can be made accessible and manageable in the wake, as it were, of a profound scientific investigation. The gap between basic research and reality disappears, with positive results for the economy and society at large.

With this book, Olaf Storbeck and Norbert Häring provide an overview of the exciting developments and insights of modern economic science, easy to understand even for the uninitiated reader. Not only do the authors analyze the relevant—and sometimes hardly digestible—scientific literature in great detail, they also challenge its claims and conclusions with an unfailing journalistic instinct for what is crucial. The result is an exceptionally competent and elegant review of state-of-the-art research. The book is perfectly suited to soften any prejudices held about economics, and to strengthen our intuitive comprehension of economic causality. With scientific journalism of this quality, we have reason to hope that soon those economist jokes mentioned earlier will no longer be understood.

1

Man—An Economic Animal?

The machine sits deep below ground, in a windowless room on the second basement level of the Zurich University hospital. The way there leads through long halls lit by cold fluorescent tubes. “Caution: Powerful magnetic field,” a sign warns at the last hurdle, a four-inch-thick steel door. Before entering the visitor is asked to hand over all metallic objects. Located behind the door is an apparatus taller than a man that resembles a computer tomography machine. It enables you to watch people thinking—it is a brain scanner made by Philips.

One wouldn't expect to meet economists at a place like this. Yet the Zurich economist Ernst Fehr conducts his research here, deep underground together with brain researchers and psychologists. The research team works on unlocking fundamental questions of human behavior and social interaction: When do individuals trust one another? When do they cooperate? What causes them to act selfishly and when do they care for more than their own narrow benefits? What conditions prompt individuals to break social norms?

A scientific revolution, at least for traditional economists. Until recently economists have not asked these types of questions. True, economics is the science of economic decisions and of dealing with resource shortages, but man himself, his likes and dislikes and the motives governing his decisions, has

PRAISE FOR
ECONOMICS 2.0

"*Economics 2.0* is a very readable and timely collection by two of Europe's best economic journalists, covering topics that range from the nature of happiness to the origins of the current financial crisis. Each chapter seamlessly blends field research in the *Freakonomics* tradition with laboratory research, and entertains while it enlightens."

—DANIEL FRIEDMAN, Professor of Economics, UC Santa Cruz and author of *Morals and Markets*

"The nature of economic research has changed drastically over the last years, revoking the mantra of rationality, exploring creative new data sources and venturing into topics far from the classical bundle of themes. This book provides a very entertaining and insightful overview of where modern economics stands today."

—ULRIKE MALMENDIER, Associate Professor of Economics, University of California, Berkeley

"The book is very accessible, yet precise and balanced in its account of what economics can teach us about the real world."

—DIRK KRUEGER, Professor and Director of Graduate Studies, Department of Economics, University of Pennsylvania

Jacket design by TIMOTHY GOODMAN

palgrave
macmillan

\$27.95 / \$30.95 Can.

ISBN-13: 978-0-230-61243-3

ISBN-10: 0-230-61243-1



www.palgrave.com

UBSD 0709
Sykt. Syidah
R M 107.90