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Interview with Richard Thaler

by *John Cassidy*

Thaler, one of the founders of behavioral economics, was out of town when I visited Chicago. I subsequently caught up with him on the phone, and I began by asking him what remained of the efficient-markets hypothesis, which he has long questioned.

Thaler: Well, I always stress that there are two components to the theory. One, the market price is always right. Two, there is no free lunch: you can't beat the market without taking on more risk. The no-free-lunch component is still sturdy, and it was in no way shaken by recent events: in fact, it may have been strengthened. Some people thought that they could make a lot of money without taking more risk, and actually they couldn't. So either you can't beat the market, or beating the market is very difficult—everybody agrees with that. My own view is that you can [beat the market] but it is difficult.

The question of whether asset prices get things right is where there is a lot of dispute. Gene [Fama] doesn't like to talk about that much, but it's crucial from a policy point of view. We had two enormous bubbles in the last decade, with massive consequences for the allocation of resources.

When I spoke to Fama, he said he didn't know what a bubble is—he doesn't even like the term.

I think we know what a bubble is. It's not that we can predict bubbles—if we could we would be rich. But we can certainly have a bubble warning system. You can look at things like price-to-earnings ratios, and price-to-rent ratios. These were telling stories, and the story they seemed to be telling was true.

So what are the policy implications? What should the government do to prevent bubbles from inflating, in the housing market, for example?

Several things. I think Fannie Mae and Freddie Mac should raise lending requirements in certain areas that look frothy. God did not say that you should be able to borrow one hundred percent of the price of a house.

What was the ultimate cause of the financial crisis? Poor regulation? Greed? Bad market signals? Human frailty?

Leverage caused the crisis—and I would say that is a pretty uncontroversial statement. Human frailty comes into play at two levels. One, the people who were taking out the subprime mortgage loans—many of them didn't understand what they were doing. Two, the C.E.O.s clearly didn't understand what their traders were doing. I call that the "dumb principal" problem. Go down the list—A.I.G., Citigroup, Bear Stearns, Lehman Brothers. These companies were destroyed or devastated by a small part of the firm that was hurtling forward and was risking the entire firm. The people in charge were either greedy or stupid, or possibly both.

What about the rational-expectations hypothesis, another Chicago theory? What's left of that one?

(*Laughs*) Is there anybody who really believes in Ricardian equivalence? That's a preposterous idea. I wonder if you can find anyone, other than, possibly, [John] Cochrane and [Robert] Barro, who has made the calculation as to what impact government spending will have on their future taxes and bequests. People don't act "as if" they were doing that either. They are ignoring it.

I spoke to Cochrane. He said the problem with behavioral economics is it is too flexible—you can use it to explain anything. He also pointed out that Robert Shiller has been calling for economics to incorporate psychological insights for thirty years, but little progress has been made.

[In answering this question, Thaler brought up the Internet stock bubble, during which shares in Palm, the handheld computing companies, were worth more than the entire market capitalization of Palm's parent company, 3Com.]

[Cochrane] has a model explaining why, during the Internet bubble, the prices of Palm and 3Com were rational. Rational models are one hundred per cent flexible. If you allow time-varying discount rates, there is no discipline whatsoever. If you look at what happened to tech stocks and then to real estate, and you say maybe there wasn't a bubble—where is the discipline in that?

I think it's fair to say that behavioral economics hasn't solved everything. That is true. But to say Shiller and I have been doing it for thirty years—there was just me and him. Now we have some young recruits. We are not outmanned a thousand to one. But there is work to do.

Do you think the financial crisis will come to be seen as a watershed for behavioral economics—a moment it became mainstream, or even dominant?

I think it is seen as a watershed, but we have had a lot of watersheds. October 1987 was a watershed. The Internet stock bubble was a watershed. Now we have had another one. What is the old line—that science progresses funeral by funeral? Nobody changes their mind.

What will happen is that the economists [in their thirties and forties] are pretty open to these ideas. They don't think it is very controversial. That's where economics will be in ten years. They will be running the subject. People like Posner and Becker and Fama and Lucas and I—we will be history.

But you don't think the financial crisis and recession will cause an intellectual revolution in economics, as happened in the nineteen-thirties?

No. Nothing will happen fast. But the next generation of economists, it is safe to say, will be more open to alternative models of human behavior and less confident that markets work perfectly.

Do you think that Chicago economics of the old school has lost some of its swagger?

No, I don't see any measurable loss of swagger. Posner goes against the grain. He's probably the counterexample to the theory that nobody learns anything. Becker and Lucas and so on—that group probably thinks he has lost his mind.

That brings us to the Keynesian revival, and to the dispute about the Obama Administration's stimulus package. What are your views on that?

The General Theory—anybody who goes back and reads that book can't help but be impressed. It contains so many insights, including many that anticipated behavioral finance. As for the stimulus, I don't know where we would be now if there hadn't been a stimulus package.

Back to Chicago matters. You say you don't see much less swagger, but I hear that there has been a lot of internal discussion, and debate, about what happened. Is that not true?

Yes. There has been a ton of discussion in the lunchroom. For six months, it was the only thing anybody could talk about. The thing I will say about my colleagues is that they were very engaged by what was going on. The good thing I will say about the Chicago School is that it was always about the world, not about the abstract. That continues. People like Kevin Murphy just want to understand how the world works.

The tradition of Chicago price theory is a good one, and it is a low-tech methodology that tries to apply simple economic theory to the world. [Steve] Levitt is a perfect illustration of that. In some ways, I, too, can fit into that definition of the Chicago School.