Unedited Event Transcript

Phishing for Phools: The Economics of Manipulation and Deception

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Peterson Institute for International Economics, Washington, DC
September 21, 2015

Morris Goldstein: Good afternoon and welcome to the Peterson Institute for International Economics. My name is Morris Goldstein. I have been a Senior Fellow at PIIE since 1994 and I will be standing in for Adam Posen as Host for today’s event.

We are in for a treat. Our speaker is Professor George Akerlof of Georgetown University. George is going to introduce his new book, co-authored with his friend and fellow Nobel Laureate Robert Shiller of Yale University called Phishing for Phools.

George doesn’t really need an introduction, but I will provide a very short one, nevertheless. He is a University Professor at Georgetown, which he joined in November 2014. Before that, he was the [inaudible 0:00:49] Professor of Economics at the University of California at Berkeley, where he has taught since 1966. In 2006, he was President of the American Economics Association and in 2001; he received the Nobel Prize in Economics for his work on Asymmetric Information and its Effect on Economic Behavior.

The game plan is as follows: George will speak for about 40 minutes. We will then turn to our distinguished audience for questions and after the Q&A, there will be a book signing for those of you who wish to purchase Phishing for Phools. So without further ado, George tell us about your new book.

George Akerlof: Thank you very much, thank you for having me, thank you everybody for coming. I really appreciate it.

So, we have this new book, it’s called Phishing for Phools and it has a very good cover, which is drawn by Ed Koren who’s a New Yorker cartoonist.

So, the official publication date is tomorrow. So I guess today is the 21st and the 22nd is supposed to be THE DAY. It’s meant to be a popular book,
but actually, it’s more than a popular book, because it is actually a book that does question lots of the foundations of economics.

There are two reasons why we made it into something that we hope is popular. The first is that we are influenced we think more than we think by popular books. And the public and economists have too great an acceptance, we think. This is our major message, of the view that whatever markets do is right. So that’s the major question that we address.

Of course, all of this would take into account the standard externalities in income distribution. But that does not exhaust the reasons why competitive markets yield bad outcomes.

So this book is going to explore the following notion; the notion that markets deceive us and manipulate us. So we have a name for this, we call this Phishing for Phools. Now all economists know this. Everybody here in this room knows this, but that leads to the second very general motivation.

The rule of what can and cannot be published in Economics leaves holes. There’s some perfectly valid and important things to say, but there’s no way to say them that would be acceptable in any economic journal.

For example, quite a few economists, maybe quite a few in this room, thought that financial derivatives would lead to the current crisis. But economists could not figure out, we could not figure out a way to express these views in the form of a paper. So, I believe, that *Phishing for Phools* is one of those holes in Economics because we all know it, because everybody in this room knows it, it cannot be published.

But because it cannot be published in journal form, then it gets ignored. And because it was ignored, we had the financial crisis and the financial crisis is the central event in the economic history of our time.

But then, the book also has a subtext. So there’s an important subtext, which gradually becomes increasingly important as the book proceeds and I’ll get to that at the very end. So I’m going to come to that at the very end, so that’s a reason for staying till the end and seeing what there is. And I think that’s also reason for reading the book beyond the talk because as a crescendo, this subtext becomes much more important and, I think, it’s actually one of the fundamental things that’s missing to almost all economic analyses as we know it.

Okay, so with these preparatory notes, okay, those preparatory notes, let me begin.
The book is based on conversations with Danny Kahneman some 25 years ago. In a conversation then he told me that the basis for Psychology was that humans are machines and they are machines that are prone to error. The job of a psychologist is to ferret out that error. In contrast, he said, the fundamental notion of economics is equilibrium. That equilibrium means that if there’s a profit left on the table, someone will take that opportunity for profit.

Now all of us know that and we see it every time we go to the supermarket. There, people sequentially line up and they choose what they think is the shortest line. And in equilibrium then, the lines are almost the same length.

So then, the question is how to put Danny’s insight into economics. So Danny’s insight says that free markets will not just provide what we really want. That is only the case if those human machines are making the right choices. But free markets will also provide us with the wrong choices and they will do so just as long as there’s a profit to be made.

So the principle that we’re going to explore means that if we have some weakness, if there is some weakness or other in the equilibrium, that weakness will be taken up. It will be taken up as long as there’s a profit to be made.

So what does that mean? That means that among all those businesspersons, figuratively arriving at the checkout counter looking around and deciding where to spend their investment dollars, some will look to see if there are unusual profits from our weaknesses. If they see such an opportunity for profits that will be, again, figuratively the checkout lane that they choose.

So as a result, economists will have an equilibrium. They will have a phishing equilibrium. That’s an equilibrium in which every chance for profit more than the ordinary will be taken up and that will include a willingness to make the wrong choices.

So let me give you three examples. The first example is Cinnabon. So back in 1985, father and son, Rich and Greg Komen of Seattle founded Cinnabon, Inc. and they had a marketing strategy. They would open up outlets that baked the world’s best cinnamon roll.

Now Cinnabon has 880 calories, which is a lot, and they have a nice motto, “Life needs frosting.” And you’ll see that frosting there. So the Komens took a great deal of effort to develop their marketing strategy, especially cinnamon, which they chose carefully, is said to attract humans by its smell, just the way pheromones attract moths.
So most of us probably take it for granted—we take it for granted that there just happens to be such an outlet right there where we’re waiting for our delayed flight or at the mall. All those outlets and all that cinnamon, which undermines our diets, they’re a natural result of a free market equilibrium. So just go to Dulles Airport, which is out that way or go to National Airport, which is over there and you’re going to find that there is such an outlet.

Okay, I’ll give you a second example, health clubs. So Stefano DellaVigna and Ulrike Malmendier report from their survey of 7500 Boston health club users that when the customers first went to the health club, they signed into contracts for which they overpaid, okay.

So they would typically be offered three different contracts; they could pay by the visit, they could pay by credit card with automatic monthly rollover unless cancelled, or they could take out an annual contract. So most customers chose the monthly contract. But 80 percent of them would have paid less by the visit. Furthermore, the losses from this wrong choice were nontrivial. It was $600 per year out of average payments of $1400.

And then, to add insult to injury, a very large number of the clubs put roadblocks in the way of cancelling the contract, such as requiring a notarized letter. Now, of course, the existence of those contracts was no coincidence. They are there for a simple reason, because there was a chance to make a profit, okay.

So now let me give you a third example, and that third example comes from Bob. Now Bob is an utter genius and only Bob could have thought of this. And it always makes me laugh whenever I think about it. So it’s a metaphor and Keith Chen, Venkat Lakshminarayanan, and Laurie Santos taught capuchin monkeys how to use money to trade. Now the monkeys developed an appreciation of price and they saved and they either did other transactions, some of them less savory.

But let’s go beyond those experiments, let’s do a thought experiment. So here’s Bob’s thought experiment. Suppose we open the monkeys up to trading with humans quite generally. We would give a large population of capuchins substantial income and let them be customers of For Profit Businesses run by humans without regulatory safeguards.

Well, you can easily imagine that the free market system with its taste for profits would supply whatever the monkeys chose to buy. So it is spec and economic equilibrium with concoctions appealing to strange capuchin tastes. But amid this monkey cornucopia, their choices would be very different from what makes them happy. So we know from Chen,
Lakshminarayanan and Santos that they love sweet fruit rollup tacos with marshmallow fluff.

Well, capuchins have limited ability to resist temptation, so we have every expectation that they would become anxious, malnourished, exhausted, addicted, quarrelsome and sickened.

Okay, so now we come to the point of this thought experiment. We shall see what it has to say about humans. So our view of the monkeys as analyzed, their behavior is if they have two types of what economists call tastes.

The first type of taste are what the capuchins would exercise if they made the decisions that are good for them. The second type of taste, their fruit rollup taste are those they actually exercise. So humans are no doubt smarter than monkeys. But we can view our behavior in the same terms. We can imagine us humans, like the capuchins, as also having two different types of taste.

So, the first type of taste describes what’s really good for us. But as in the case of the capuchins, that’s not always the basis for all of our decisions. The second concept of taste is the taste that determine how we really make our choices and those choices may not in fact always be good for us.

So the distinction between the two types of tastes and the example of the capuchin give us an image. We can think about our economy as if we all have monkeys on our shoulders when we go shopping or when we make economic decisions. And those monkeys that are on our shoulders are in the form of the weaknesses that have been exploited by marketers for ages.

Because of those weaknesses, many of our choices differ from what we really want or alternatively they differ from what’s good for us. So we’re not generally aware of that monkey on our shoulder. So, in the absence of some curbs on markets, we reach an economic equilibrium where the monkeys on the shoulder are substantially calling the shots. So let me now make a note and that is we think, “Oh yeah, the capuchins, humans are so much smarter than the capuchins.”

But you have to remember something, the capuchins can’t read, so how about those advertisements that would be advertising us and they’re tricking us, they would mean nothing to the capuchins. The capuchins just go and they take their marshmallow fluffs. We, in fact, we have a whole array of ways in which people can get to us, where they are going to have no effect whatsoever on the capuchins.
Okay, so where does this fit into economics. So this really fits into something that’s actually fairly important in economics. So let’s go ahead and I’ll just describe this in more detail.

Adam Smith, as we all know, back in 1776 wrote the following, “That with free markets, as if by an invisible hand, each person pursuing his own interests, also promotes the general good.” Now there’s a modern rendition of this statement and that is that competitive free market equilibrium is Pareto-optimal. So what does that mean? That means that once such an economy is in equilibrium, it’s impossible to improve the economic welfare of everyone. So any interference would make someone worse off.

The theory, of course, recognizes some factors that might blemish such an equilibrium of competitive free markets, such as externalities in bad distributions of income. But with these qualifications, the result is believed to be true. But then with completely free markets, there’s not only freedom to choose, but then there’s also freedom to phish.

Now it’ll still be true, now this is the thing, the Pareto still goes through. It will still be true following Pareto that the equilibrium will be optimal. But it will be an equilibrium that’s in optimal, not in terms of what we really want. It will be in an equilibrium that’s optimal instead of terms of our monkey on our shoulder tastes. And then for the monkeys and for ourselves would lead to manifold problems.

So standard economics has ignored this obvious difference because most economists have thought that for the most part, people do know what they want. That means that there’s nothing much to be gained from examining the differences between what we really want and what those monkeys on our shoulders are instead telling us.

But that ignores something, that ignores the field of psychology, because this whole field of psychology is, or at least most of it is about the effects of those monkeys on our shoulders. It also ignores the fact that the competitive equilibrium will also involve people generating information that will lead us astray insofar as it is legal and insofar as there’s a profit to be made by it. So in terms of our book, markets enable phishing for phools.

Okay, so let me give a more precise definition of phishing for our purpose. So phish is a recent word. It’s computerese. And free markets open us up to those who seek to influence us to do what they want, but that’s not necessarily good for ourselves. They allow us, in other words, to be phished. And so this is particularly appropriate for the Peterson Institute,
we live in a world where some five billion adults can phish us for being a phool.

So we intentionally opened ourselves up to such exploitation because of the obvious advantages, but then we must also think about the other side of the board.

So what is a phool with a PH? A phool simply is someone who is successfully phished. And our view of a phool is everybody’s a phool. We all have our weaknesses, we all have our weaknesses some place, and so a phool is in some sense an intelligent person, a phool is in some sense just somebody who’s human.

Okay, so the onus is now on us. The onus is on Bob and myself in the book to indicate that in real life this equilibrium does affect our lives. So, you know, I must confess before I wrote this book, I always thought pretty much, all the decisions that we made the right decisions pretty much, subject to all kinds of problems of information and that.

But actually having written this book, I’ve actually changed my mind. Now, of course, I spent five years writing this book and Bob has spent five years and we’ve had a research assistant. But the fact is, I seriously believe that this is a major problem and I’m going to give you four reasons why. There are four areas—so if there are four areas of what we call, “Nobody could possibly want.” And I’m going to give you those four areas.

First is personal financial insecurity. Fundamental fact of economic life has never made it into the economics textbooks. Most adults, even in rich countries, go to bed at night worried about how to pay the bills. Economists think that it’s easy for people to spend according to budget. But we shall see later that it isn’t. Now no one wants to go to bed at night worried about the bills, but most people do.

Area two of nobody could possibly want is financial and macroeconomic instability. So phishing for phools in financial markets is the leading cause of the financial crises that lead to the deepest recessions. So in the 1920s, it was Swedish Matches with Ivar Kreuger of Kreuger and Toll. In the 1990s it was the dot coms and in the 2000’s, it was subprime mortgages with Angelo Mozilo of Countrywide and his like.

So every time it is different, the stories are different, the entrepreneurs are different and their offerings are different, but also every time it is the same. There are the phishermen and there are the phools. And when the buildup stock of undiscovered phishes named the Bezel by John Kenneth Galbraith gets discovered, asset prices crash.
So on the last crisis the investment managers who had purchased the packages with the bad mortgages in the buildup to the crash, could not have possibly wanted them. And so, we shall return later to that in the talk. So area three of nobody could possibly want is ill health. Here we discuss how the pharmaceuticals do their phishing and how the phood industry (with a PH) fills us with sugar, salt and fat. In its five year career just to give you one example. Vioxx is estimated to have caused 26,000 to 56,000 cardiovascular deaths in the United States alone. Failure to notify women of suspicions about Premarin, a hormone replacement, is estimated to have caused some 94,000 cases of breast cancer. So nobody wants bad medicine.

About 69 percent of American adults are overweight and more than half of them, 35 percent, are furthermore obese. Yet no one wants to be obese. And then there is tobacco; no one wants lung cancer and then there is alcohol; no one wants to be an alcoholic.

Okay, so bad government. Just as free markets work at least tolerably well under ideal conditions, so does democracy. Politics is vulnerable to the simplest phish whereby politicians silently gather money from the interest and use that money just to show that they’re just one of the folks.

So our later chapter gives the example of a campaign by Charles Grassley of Iowa, who gathered a multimillion dollar war chest. And then he showered the state with TV ads where he’s just one of us back home and he’s riding his tractor lawnmower in concentric ellipse and just showing the people back home that he’s just like them with his tractor lawnmower.

And also, he has the most beautiful lawn, you know, it’s just a beautiful picture. There’s a marvelous red barn in the backyard and there’s Grassley, you know, and you see this beautiful grass emerging.

So almost no one wants a democracy where elections are bought in this way. I think I’m going to skip the next two slides; these are the slides about the 19th century before we had regulation and then I take you to something meatier. So this takes us to the first major chapter of the book.

So as we all know, probably everybody here recognizes this person. Susie Orman is a popular TV figure and as we all know, if we’ve ever watched her for more than a few seconds, she gives very loud and shrill financial advice. But, her audience seems to adore her and lap up every word. So when I asked an economist friend of mine at the IMF about her, he had the predicted reaction. He had watched her for only 10 seconds and he simply could not stand her “Mommy knows best” voice.
Furthermore, he found her investment advice simplistic, which I don’t know how he managed it in his 10 seconds, but I think he did. But that does not explain why Susie Orman’s audiences lap her up. Her most popular book is called, “The Nine Steps to Financial Freedom; Practical and Spiritual Steps So You Can Stop Worrying.” So let’s contrast what she tells us there with a portrait given of consumer spending in the Economics textbooks.

So according to Economics textbooks, we decide on our demand for the proverbial apples and oranges by having a budget for our spending and then we choose the combination of apples and oranges along there that will maximize our happiness, that maximize our utility. But Susie Orman’s financial advice books tells us the consumers do not follow such a textbook protocol in their purchases. So how could consumers do anything better than what the textbooks describe?

Well, I’m an economist, I couldn’t imagine not doing--and I think, when I do go to the supermarket, I do that stupid thing that we’re told to do in the textbook. But she tells us that people actually do something different because people have emotional hang ups with regard to money and with regard to spending it.

So what she found, as a financial advisor, is that they’re not honest with themselves and as a consequence, they do not engage in rational budgeting. Well how could she know? Well, as a financial advisor, she had a test. She asked her advisees to add up their expenditures and those expenditures all but invariably fell short of what a documented accounting from the record later turned up.

So figuratively what were people doing? So relative to the proverbial trip to the supermarket to buy those apples and oranges, it’s as if her advisees spend too much in the fruit section. And by the time they reach dairy products, there’s nothing left over for eggs and milk.

So in real life, such budgetary failure translates into having nothing left over for saving. So this failure, this failure to deal cognitively and emotionally with money, says Orman, leads to those unpaid bills. So it’s her mission to keep those bills down, so that her readers and her clients will no longer worry at night. So that’s the role of Mommy and also why those audiences excuse that Mommy knows best.

So it’s worth noting and this is more than parenthetical that worry, as noted in Orman’s subtitle, are central concerns of the financial advice books, but you will never find that in the index of an economics textbook.
So we don’t just need to take Orman’s word for it, we can put together a statistical story and that indicates that a very significant fraction of consumers are worried about how they’re going to make ends meet.

So a paper by Annamaria Lusardi asked the question, “How confident are you that you could come up with $2000 if an expected need arose within the next month.” So almost 50 percent of US respondents replied either that they could not or they probably could not come up with the needed $2000 dollars, even though they were being given a whole month to do so.

The same difficulties regarding finances can be gleaned from a survey of consumer finances. In 2004 a rough accounting indicates an average of about $10,000 of financial assets held by the bottom 50th percentile of the population and most of those financial assets were then liquid in some way or other.

For British workers paid once a month, their expenditures are down a remarkable 20 percent in the week before their next paycheck. And then we have the number of bankruptcies. By my estimate, there is something like a 20 percent chance that someone in the United States will go bankrupt over the course of their lifetime.

And there’s a sociologist at Harvard who has estimated for Milwaukee the chance of being evicted per year for the whole population of Milwaukee and he finds that to be 2.5 percent, which is really amazing. Actually I believe he’s made an over estimate, but even if it’s half that, it’s still an amazing thing to have 1-1/2 percent that you’re going to be a poor person out on the street, 1-1/2 percent per year.

That means over a ten-year period, you’re going to have 15 percent of the whole population of Milwaukee. So I’m doing half of his number and 15 percent of the population is going to have that terrible thing happen to them.

Okay, so this poses a problem, a theoretical puzzle. The Susie Orman view of the world suggests that people are spending too much and they’re worried as a result. So that leaves the question why. So there’s another perspective on this. So back in 1930, John Maynard Keynes wrote a short essay on what life would be like for our grandchildren 100 years later.

In one respect, Keynes was totally correct, he predicted that real income would be some eight times higher. So far income has increased six times and he’s right on target for 2030. But in another respect, Keynes was totally off the mark. He did not predict that the grandchildren would be going to bed worried about their next shilling. Instead, he said they would
be worried about how to use their surfeit of leisure. I see everybody in this room and their respective spouses worried about their surfeit of leisure.

So he failed to predict the housewife who was exhausted from the first and then from the second shift. But the perspective our book coupled with listening to Susie Orman, gives us the reason for this.

So what’s the answer to the puzzle? Well, we know the answer to the puzzle, it’s there in this general equilibrium theory. So, in some sense, what we think we’re doing in this book, I always thought general equilibrium theory was rather dull and boring. But for me, writing this book has brought general equilibrium theory to life.

So in the United States the goal of almost every business person is to get you to spend your money. So life in a capitalist economy is a continual temptation. So think about it, just walk down a city street, walk down Connecticut Avenue. The shop windows are literally there to make you come in and buy.

An example comes from the old days. In the US in the old days, I’m old enough to remember that Pet Shops used to have puppies in the window and you were supposed to see those puppies and you were supposed to come in and buy, they were so cute. And so there’s even a popular song about it. So Patti Page, the singer, coming down the street, sees such a puppy and so she bursts into song. She sings, “How much is that doggie in the window, the one with the waggly tail. How much is that doggie in the window, arf arf, I do hope that doggie’s for sale.”

Well, you’re not going to buy the book because of my singing, but the remarkable thing about that song, that song is about the fact that they have that doggie in the window and they’re going to entice you to a sale.

Now the remarkable thing that I didn’t realize, actually probably until after the book was written, was that the rest of the song fits our book just totally magnificently because our book is about the two sides of markets. They’re wonderful, they give us what we want. It’s really tremendously amazing that all of the luxuries that markets give us and that they’ve developed just in the last 150 years.

But then, there’s this bad side to markets. So let me tell you about the subsequent verses. So in the subsequent verse, she says, “I’m going to take a trip to California and leave my poor sweetheart alone. If he has a doggie he won’t be lonesome and the doggie will have a good home.” And then she goes on, she continues with her song, it’s very nice though.
Okay, now think about it, okay. The interesting thing about this song is that it has this ambiguity to it. On the one hand, this may be the most lovely young woman in the world and she has to go to California and there she has this wonderful love affair with this boyfriend and she’s going to buy the doggie. And every time that the boyfriend sees the doggie, he’s going to have a memory of this wonderful love affair he has with this wonderful woman.

So that’s story one. But there’s also the other side to this story. Here’s this scatterbrain woman, she’s leaving this guy. It’s been a disastrous affair. She goes off to California and there he is left with this doggie and this poor guy, he doesn’t know what to do with the darned thing. He has to walk it, he has to take care of it, and every time he sees it and the doggie wags its tail, he’s reminded of this failed love affair. So there you are. But that’s the point of the song is that markets have these two sides and that’s the point of our book.

So that’s the first message. So in the shopping mall and in the supermarket, temptation is there. These invitations, these attempts to lure us are simply pervasive. So they’re there when we rent an apartment, when we buy a car, when we buy a house, every time we use our credit card. So the idea of tempting the consumer to buy to spend your money is at the heart of free market capitalism.

Okay, so that’s the first story. Let me give you a second story, so that’s endemic temptation, I’ll talk about the financial crisis, let me see. I’m doing okay for talk.

So there are hundreds of books on the financial crisis. The typical one is 500 pages long. The typical one, as I’m sure everybody here knows, tells the story of my institution. For example, it’s about Lehmann or Goldman Sachs or Fannie Mae-Freddie Mac or the Fed or Treasury or Bank of America or City Corps and they go on and on and on forever and they’re also very good--or the best ones are very good.

Implicit in each of these is that my institution is central to the crisis. Now the aim of our chapter on the financial crisis, we have three chapters, which gives us a different feeling for what financial markets are all about. The aim of our chapters on the financial crisis is due to the opposite. So on “The Financial Crisis” is to tell the story of the crisis in general terms. So scratch any economist and we will go into economic speak. So we’re trained to think in terms like supply and demand and this means that we often ask very good questions and that we have good analyses of problems.
So *Phishing for Phools*, is an offshoot, it’s an offshoot from how we standard economists typically do our analysis. But it’s not so standard—it’s not so standard that every economist was asking the right questions in the build up to the crisis. But we should have been because *Phishing for Phools* gives us an extremely succinct explanation for what happened and let me give you one rendition for that.

Okay, so a reputation one. If I have a reputation for selling perfect, beautiful avocados, I have an opportunity. I can sell you a rotten avocado at the price you would pay for the perfect ripe one. I will have mined my reputation, but I will have also phished you for a phool. So there we have the avocado.

So, such a story lies at the heart of the continuing financial crisis that dominates the economics of our times. The reputation mining in question involved the subversion of the system for rating fixed income security. So the reputations of the ratings agencies; Moody’s and Standard and Poor’s, have been built up over the course of almost a century. Their job was to rate bonds on their probability of default.

In the late 1990s and early 2000s the ratings agencies took on themselves the task, not just of rating bonds, but of also rating more complex derivative securities. The complexity of the payment structures made them somewhat hard to rate, but something else made rating all but impossible. The underlying assets such as mortgages were all but inaccessible to the raters. But the public, the public out there would believe whatever ratings were given to them by the agencies.

And an industry then grew up, an industry grew up to do a reputation mine. So by analogy, by analogy rotten avocados were being labeled perfect and with that label they commanded premium prices and so what happened was a whole a Central Valley full of growers went into the profitable business of producing such avocados. So this mining of the ratings is the basic story, that’s the basic story of the financial crisis.

Well that’s not all of the story as you all know. It’s not all of the explanation. So we must also explain why the production and sale of those over rated securities brought down the financial system. And the answer again is simple. The value of these securities reflected these ratings. So that enabled commercial banks and investment banks, and also hedge funds to borrow huge amounts of money short term. Invest in the over rated securities and pocket small profits from the interest spread on every dollar of investment. They took on a lot of leverage.

So that borrowing was made with the rotten securities as collateral. For the moment, they seemed as good as gold. The ratings indicated that there was
almost no chance of default. But then, as we all know, the truth was discovered. Those avocados perfect as they were on the outside, were really rotten on the inside. So they were worth much less than the bankers and finance managers had paid for them. And so from Frankfurt to New York to Rakeovic, financial institutions owed much more than they owned. Without bailouts, they were bankrupt.

So, the chapter then gives the historical answer to four questions. One; how did the rating agencies initially establish their reputation? What then changed, making it more profitable to mine that reputation than to keep it? Why were the buyers in those rotten asset securities so naïve? And then why was the financial system so vulnerable to the discovery that the assets were rotten?

So now I’ve given you sort of two sort of detailed examples of the type of thing that you’re going to find in each and every chapter of *Phishing for Phools.*” And so these are the chapters. The chapter on Advertising, Cars, Houses, Credit Cards, on Lobbying, on Food and Drugs, Inventions, Tobacco and Alcohol, there’s much more on the financial system that I think gives a much better picture than you’ll get from the textbooks about how the financial system work.

We talked about protections against *Phishing for Phools,* why in fact, our lives are actually quite tolerable despite this and then there’s a conclusion and where this fits into economics.

Okay, so now let me make some concluding remarks. So what I’ve described here is I’ve described the beginning of the book. In the second half, the book introduces a new concept. It gives a picture, perhaps not totally general regarding why and how we are phished for phools. Again it has to do with being human. Now this is something that for the most part we don’t see in economics and we don’t see in current economic methodology.

Again, this has to do with being human. So we’re constantly telling ourselves a story regarding what we do and who we are. So think about yourselves right now and here in this room. Each and every one of you who are sitting in your seats and me who’s giving this talk, we have a story. We have a story, which is telling us what we’re doing and then we act accordingly and we play our roles, we do our parts.

So, telling ourselves a story is basic to how we think and is basic to what we do. Psychologists have different names for these stories. They call them such things as mental frames or scripts or narratives. But then it’s in the nature of the stories that they can have grass or new offshoots. So, that’s the result of all advertising.
So what do advertisers try to do? The role of advertising is to graft the advertiser’s story onto the story the people are already telling themselves. So, that’s the story of the doggie in the window. The girl’s walking down the street and that advertisement, that doggie with its waggly tail attracts the girl’s attention and then she bursts into a new story and she’s going to buy the doggie and give it to her boyfriend. But that’s, in fact, a metaphor for what huge amounts of economic activity is. We always want to--we want to attract people to do what we want them to do and to notice what they do.

Now, such stories play a very important role in people’s motivations and so that concept then pervades the second half of the book, regarding advertising, buying a car, lobbying the phishing by the pharmaceuticals, tobacco and alcohol and financial markets as well.

So let me give you one example of that. So, in the chapter on Tobacco and Alcohol, this message is especially clear. So, everybody here knows about the Surgeon General’s report. I doubt that many of us have actually sat down and read it, although it is actually a very well written document. And we also know something about the subsequent anti-tobacco-ing.

Now that’s been successful for the following reason; what did the Surgeon General’s report do? It propagated a story and that story—and it can be said in three words and that story is smoking is stupid. Now almost everybody that we know believes now that smoking is stupid. Even most smokers; 67 percent of all smokers say they want to quit. So that’s what it did.

Regarding alcohol, whose harms are quite possible also very large, the fact is we don’t know, there is no such story. And there’s virtually no movement even to do research to evaluate those harms. So, there is a dual career for tobacco, which has somewhat been brought under control. It’s still a very serious danger. But we don’t even know how much the harms are that are due to alcohol. All we know is we have occasional anecdotes about that.

And as an indicator of that, the taxes on alcohol are very low. For example, the federal tax on a bottle of wine is 21 cents and the Massachusetts State tax on a can of beer is only one cent. So I hope I’m right about that. I’ve looked it up five times, so I’m probably right.

Okay, so this takes us to a final message of the book about the role in economics. Economics tends to disregard the role of stories. Now we saw that in the Susie Orman example. Standard tests work just as soon as the people maximize their utility subject to their budget constraint. They do
that textbook-y thing. But that does not capture what Tim and Sue really are thinking in the supermarket when they’re choosing their apples and oranges, so they’re broke at the end of the month.

So as economists, we have a duty to go out and ask and this is a duty that we haven’t been taking on ourselves. What are people really thinking when they make their decisions. The role of stories which takes center stage in the second half of *Phishing for Phools* is then its second important message.

And then the concluding chapter then, appropriately I think, is about how a wrong national story in the United States is about the unambiguous benefits of free markets and how that’s led to dysfunctional national policy.

So, the chapter gives three examples of this wrong national policy regarding Social Security, regarding budgets for the SEC, and regarding campaign finance reform. But, of course, the whole book is about, just to repeat, is about how economics is about telling the right story. And those stories are very important and they tend to be a very important thing that’s left out of most of our economic analysis and it’s also left out of the mathematical models that Political Science does tell about politics, although politics is really super about that. So thank you.

Morris Goldstein:  Thank you very much. Okay, I put it over here. Thank you. Okay, wow George, that was terrific. We’re now going to open up the discussion to questions. Please identify yourself and try to keep your questions relatively short. To get the ball rolling, let me use the prerogative of the Chair to ask an opening question.

In the book, you talk about resistance to phishing and its heroes and I was hoping that I could get your reaction to two resistance organizations; one from the private sector and one from the public sector.

The first one is firms like Angie’s List, which for a modest fee provide reviews on local service providers. So, if you want to get your driveway paved or you want to get a plumber, you just type in the service that you want and you get the reviews rated by the customers, very detailed. Cost, nature of the job, how promptly they responded, the quality of the work and for the bigger, for some of the firms that are used the most, you might have 25 or 50 reviews and most of them are in the past six months.

So if someone’s trying to phish me, an unscrupulous provider, it’s going to be harder for them to mine their reputation because as soon as they do that, they get negative reviews and other people read about it and they lose their business. So the general question I’m asking about that is, well if
there are these things that are going on. In a way, there’s money on the table for someone to do anti-phishing.

George Akerlof: Yeah.

Morris Goldstein: Why isn’t it possible then for those businesses, their for-profit businesses, to do that and offset the effects of phishing? The other one I was…

George Akerlof: I was going to answer…

Morris Goldstein: No, go ahead.

George Akerlof: Okay, okay, that’s a very good question. Okay, so I guess there’s a chapter about institutions that have grown up. I like your example of Angie’s List. Do I worry about Angie’s List? Yeah, I sort of do worry about Angie’s List because I use Angie’s List and then I feel sorry for all of those other people who are down the list who are probably quite good. And so, yeah, these things, so there’s all kinds of reputation institutions, which help us like Angie’s List.

Our example was the Better Business Bureau, but I think you’ve actually come up with a better example. A better example, but then there’s a problem. But then there are problems for which an Angie’s List just simply isn’t going to help us and that is if the Angie’s List person comes and they convince you that you really need a repair that you actually didn’t need and you think that you’re perfectly happy.

So we talk about people who are emotional phools you don’t get defense from being an emotional phool by Angie’s List, just an informational phool.

Morris Goldstein: Okay, the other example is a consumer financial protection agency, which addresses many of the things about credit cards and mortgages that you talk about.

George Akerlof: Yeah.

Morris Goldstein: But again, that is about informational phishing, not emotional phishing. So anyway, let’s open it up.

George Akerlof: Okay.

Morris Goldstein: Yes.

Slavi Iyeto: I am Slavi Iyeto of the Cato Institute. You know, it is easy to say that the markets are imperfect, but the human beings are imperfect.
George Akerlof: Yeah.

Slavi Iyeto: If markets are supposed to deal with human beings as they are, then blaming the imperfections of the humans on the market, I think gets the thing slightly, you know. I mean let’s get to a nonmarket area like politics. In politics, are people phishing for phools, absolutely. Every single politician is phishing for phools. I would look at religion. Every religion in my view is phishing for phools. You are reaching out and getting for all those guys. So you don’t have to be part of the market to be phishing for phools. Phishing for phools is built into all human behavior. If you want to say something significant, you have to show me what it is, which makes this market thing different from phishing for phools in areas like politics, customs, choice of color of your wife. I mean a thousand areas where you find similar kinds of phishing and it has to do with the imperfection of human beings, not the markets.

George Akerlof: Okay, so I disagree with that 100 percent, with your question. There is a view regarding economics and it’s a correct view that markets give us a very good and they give us something that would be called optimality. You say, what Williams said is this view of markets, which is held by most all economists under the appropriate conditions, we say that there is a further theorem in which markets don’t just have their good side, markets also have their bad side.

Now, I agree with you, I think there’s phishing everywhere, so I’ll give you an example. I hope I can do this, fine. So I’ll give you an example where this occurs in religion, you know. Here we are, we’ve got the phish for phools. So, my view is that all of this occurs because we’re human and this is part of what we do and it goes way beyond, and so it goes way beyond.

Now you mentioned politics. Okay, so I think I actually have read, but I may not have done a sufficiently careful job of the Political Science models of voting behavior and so forth. Okay, what they talk about is they talk about informed versus uninformed voters. But if you read the book, I think we actually give a picture of that, which is much closer to reality, so we take the Down’s model. But then we show that in fact, when you take the Down’s model, you get something that actually gives you, I think, something closer to reality. And I think it gives us a better picture of what the politics are.

And then what we say there, and this is what happens in crescendo throughout the whole book into the latter half of the book, is that it all as to do with what are politicians trying to do. They’re trying to tell their story. So Grassley out there with this lawnmower saying, “Grass-ley,
Grass-ley, I like to come home to Iowa and mow my lawn just like all of you folks.” They’re telling a story about who he is.

So, you know, I feel a large part of this book is how people are motivated by stories and I think that’s what you were telling me. And we have these stories; sometimes they’re right and sometimes they’re wrong. And that’s what being human is all about.

So this is talking about how this aspect of our being human affects markets and our view of markets. But, of course, it affects everything else. So I agree with you 100 percent that it effects everything else. I disagree with you 100 percent that applying this to our theory of markets is inappropriate. Okay, so that’s my answer, do you want to say more, or that’s good, thank you.

Slavi Iyeto: [Inaudible 00:55:39].

George Akerlof: Yeah, right.

Slavi Iyeto: You said for instance that some things should be a no brainer. That there are questions of financial insecurity, financial macro instability, ill health, government.

George Akerlof: Yeah.

Slavi Iyeto: All the Communists and Socialists said capitalism gives you these four bad things, therefore you should go for Communism or you should go for Socialism.

George Akerlof: Okay, so we left out the chapter on, we had a chapter on Socialism and that may or may not come out in an economics journal. I mean the worse story ever was the story that the Bolsheviks told and it just makes me angry every time I think about it. But, the thing is we weren’t talking about why, we’re not in 1917 and I wasn’t telling you why we shouldn’t have the Russian Revolution.

Morris Goldstein: Yes.

Colin Hendricks: Hi I’m Colin Hendricks, I’m here with the Peterson Institute. I’m interested in the extent to which there’s a theory of preference formation in the book and I’ll illustrate what I’m confused about with an example. So if we decide that there is a person who lives here in the District in a small apartment, who lives in a very, kind of confined urban area and they decide that they want a full sized pick-up. We don’t know why they want the full sized pick-up, but they go around and they shop Dodge, they shop
Chevrolet, GMC, Ford. They get the best price possible for that full sized pick-up. Have they been phished?

George Akerlof: Yeah.

Colin Hendricks: They have?

George Akerlof: No, I’m not telling you whether they have or not. The point is, the wonderful thing about general equilibrium theory, is it holds no matter over all utility functions and overall production functions up to certain specifications. Our theory is we don’t need to tell you for this that exactly what peoples’ specifics—we don’t need to tell you that when they are, but we will know that they can be phished for phools.

So if the people have this weakness, then in fact the markets going to be there. So the book begins with a vignette about Molly. Molly is an addicted gambler in Las Vegas. And so there’s a clear example of somebody who’s been phished for phools. And not only has she been phished for phool, the amazing thing about Molly is Molly knows it herself.

She doesn’t go to the gambling casino to win, she goes because she knows she’s addicted and then she’s going to push that red button and she’s going to keep pushing it until she’s out of money and then she has to leave. And this is making her life an utter hell.

So the fact is we don’t need—we’re giving examples in the book, examples where it’s unambiguous about being phished for phools, so maybe you’re a couple. I think the way you describe it, I think you think the couple was phished for a phool. Uh, my deal is, “Yeah, probably, but maybe not.”

Morris Goldstein: Yes.

Mark Tokaloff: Yes. I thank you for a wonderful presentation.

George Akerlof: Thank you.

Mark Tokoloff: I’m Mark Tokaloff from the Korea Economic Institute. Outside the room there’s a table with a very attractive set of books on it with a very attractive cover written by a justly renowned economist. I’m tempted to part with my money to buy that book, but how can I tell if I’m making a rational choice or if I’m giving in to my book addiction?

George Akerlof: Okay, so yeah, I think this is an answer to your question too. So Molly, when Molly goes to the slots. When she’s off the slots, she knows that this
is her problem. She goes to Gambling Anonymous and she takes medication for it. So, I think, one way to know that you’re being phished for a phool is when you put yourself in your quiet, rational state of mind, you can say to yourself, I shouldn’t have done that.” And you can say, “I was in a bad moment when I did that.” So, that’s a way in which—so I think, all of the major examples in the book, the people would say, “Yeah, I shouldn’t have done that.”

Now the other thing is that there are all kinds of market mechanisms. There’s information phishing of various sorts and we talked about the information phishing with respect to the marketing of Vioxx. And there, of course, the people would automatically say that they’ve been phished for phools. So Vioxx, you had just a huge increase in your chance of having a stroke when you took Vioxx. Yes.

Speaker: About the same time that Patti Page sang about that doggie, there was a book called Hidden Persuaders. I wonder what we’ve learned since then.

George Akerlof: Okay, so yeah, so actually Hidden Persuaders, Bob and I both read it when we were teenagers and Hidden Persuaders, at least by its title, it indicated that it was hidden persuasion. Here, this stuff is all out in the open. Molly knows she’s going and she’s pushing this button. So the thing is, what’s new to this book is bringing it into Economics. So it’s uniting the Economics and the Psychology. But this is an equilibrium.

So, what’s the major message to this book. The major message of the book is that if something like Cinnabon can make a profit on selling you on those Cinnabons that are going to get you to trash your diet, then it’s going to be there. So, this is an economics book. You read the book and each and every chapter has something economics in it. So, it’s very different. Hidden Persuaders is a good book. So, this is what Bob and I both remember about it.

We remember that housewives—that cake mixes required that you add an egg. Do you remember that one? Yeah, okay, so the reason was that the housewives who were then making cakes wanted to feel that they were adding something to the product and so was their product.

Speaker: [Inaudible 01:02:40] at that company.

George Akerlof: Oh yes, I remembered that one, that’s right. But this is actually quite a different book and it’s different for the reasons Danny said. Danny said, “Psychology is about how we’re fallible machines. Ours is about how we’re fallible machines and then there’s an equilibrium.” And so the equilibrium is the cut point. And then that’s, in answer to your question, is the equilibrium and the fact that we get this thing at an equilibrium that is
the cut point. And that’s why we have an equilibrium where the financial markets fail.

So another advertisement—I’ll give you another advertisement for the book. I think we give a different view of financial markets. So, there are three chapters on financial markets. I think we give a different view of financial markets than you learn from financial textbooks, and I think, it gives you this picture of the financial market that not only are they the place where you have all this nice, intermediation, which is probably necessary, but it’s also a form of gambling casino and it’s not so easy to find that actually written in books on economics.

George Akerlof: Okay, thanks.

Morris Goldstein: Any others?

George Akerlof: Yeah.

Peter Harry Woo: My name is Peter Harry Woo and I’m the Director of Log Irish Foundation. It was very strange when I got an invitation from Adam Posen to come to this meeting. I think you never know about me, I never heard about you too and I have no connection with an economic issue at all. I was in China 19 years in the labor camps, so I come here mostly talking about human rights issue. So I don’t know why they got me an invitation to come to this meeting.

But I want to say in China, many men, three million prisoners and all of them, they’re workers. It’s a huge system, economy systems. And one of the camps, I can give you the size, 162 square kilometers. Two times Washington DC area, big, huge. China have a huge labor camp system. And at the beginning, 1950, 1949, the Soviet expert helped the Chinese to build it. I don’t know that I met…

Morris Goldstein: Excuse me, I don’t want to interrupt you, but do you have a question for Professor Akerlof about the book or about economics or are you?

Peter Harry Woo: I’m sorry, I got an invitation to come to this meeting. That’s why I don’t know why, I feel very strange, I told you that is my situation, why I came over here.

Morris Goldstein: Well I appreciate, I appreciate that, but I think we need to keep the--?

Morris Goldstein: Okay.

George Akerlof: Okay, so let me give an answer to this, I do have an answer.
Peter Harry Woo: So if you don’t like, next time don’t send me an invitation.

George Akerlof: No I’m happy, I like your question and I’m very happy you’re here. Okay, can you just maybe just finish a little bit so I can know your question? And the question was, aren’t we being – so let me continue. So thank you, thank you.

So I think that this book has relevance for China too. So look, I don’t want to say anything, I think those labor camps are really, really terrible, of course. But then I also think that China has to be very careful about going into a market system. It has to know that there are both good things about the market system and bad things about the market system.

And so, you can’t just be too much of a market system fundamentalist. So, I think the major view of this is Bob and I just start the book and we say, “There are these wonders of the market system, that’s one. But two, at the same time that there’s these wonders of the market system, there are these disadvantages. And I think that in the United States and this is a book mainly about the United States, that we’re looking at the market system with rose colored glasses and I feel that that has impeded having good government and good policies and this is a book which is aimed to show that yes market system is good.

But, we all love our children and our spouses and everything else. But there are times when, you know, when they don’t do everything that we like and so we should say the same thing about our market system. We like our market system. We like our political system. But we should also, if we’re going to have a good political system and a good economic system, we also have to know where they don’t perform and do exactly what we want.

So thank you very much for coming and I hope you’ve enjoyed the talk and maybe this is relevant also for China.

Morris Goldstein: Thank you all, thank you all for coming.