The Invisible Hand is Invisible because It Ain't There—Joseph Stiglitz

John Komlos, reply to Alan S. Blinder

In response to:

"What's the Matter with Economics?" from the December 18, 2014 issue.

Alan S. Blinder is critical of Jeff Madrick's characterization of the role of economists in the financial meltdown of 2008. Madrick suggests that their role was "central" while Blinder claims that economists contributed merely a "bit" and even that bit was limited to "conservative economists". I side with Madrick's characterization and so does the Nobel Prize winning economist Joseph Stiglitz: "I have to blame my colleagues in the economics profession. Not all economists got it wrong; but a lot of them did and they provided arguments that politicians used, people in the industry used for stripping it [regulation] away…. The basic argument was a very simple one, a variant of Adam Smith that markets, unfettered markets always lead to efficient outcomes…. they [regulators] were just doing what they said economic theory said you ought to be doing."[1]

Thus, Blinder has turned a blind eye to the dominant spirit of our times that can be traced back to the immense influence of Milton Friedman's concerted effort to discredit government's legitimate role in the economy in his influential PBS series "Free to Choose" broadcast in 1980, aired again in 1990, and accompanied by his best-selling book of the same title. Friedman may well have been "far to the right" as Blinder suggests, but he nonetheless had immense influence also on the center and made even liberals such as Bill Clinton endorse the Financial Services Modernization Act of 1999—with well-known consequences—at a time when his Council of Economic Advisors was chaired by non-other than a liberal economist by the name of Janet Yellen.

In fact, the main message taught to millions of economics students year in and year out practically in all courses is that, in the main, regulation of the free market is not only superfluous but decreases efficiency, stifles investments and innovation, and is therefore detrimental to economic growth. Sure there are some moments devoted to addressing the exceptions to this generalization but they are treated as epiphenomenon and as Madrick and Stiglitz emphasize, the takeaway is that the government is a boogeyman that does more harm than good. Without such a chorus of economists singing the praises of *laissez faire*, as though markets descended straight from heaven, the decades long process of deregulation that gnawed away at the stability of the financial system created under FDR and ended what Paul Krugman calls "boring banking" would have been unthinkable. Blinder should really watch again the film *Inside Job* which outlined so well the succor economists of all persuasion provided to the deregulation hype–a condition *sin quo non* of the fragility of the financial system and the Meltdown of 2008.

And not only conservative economists taught and practiced these principles. It is fair to say that Larry Summers is a liberal economist; yet he eagerly aided and abetted Alan Greenspan in running Brooksley Born out of town after she dared to defy them and attempted, albeit

unsuccessfully, to begin to regulate derivatives in 1998. And those who warned of the inherent instability of the financial sector unless the government maintained its constant vigilance, such as Hyman Minsky, were ridiculed and even ostracized by most everyone in the profession including Blinder's colleague, Ben Bernanke who is not known as a staunch conservative.[2] Bernanke disdainfully dismissed such warnings by writing, for instance, that, "Hyman Minsky (1977) and Charles Kindleberger (1978) have in several places argued for the inherent instability of the financial system, but in doing so have had to depart from the assumption of rational economic behavior."[3] In other words, there is no need to worry about the ideas of people as bizarre as that…. Thus, it seems to me that it is fair to infer that the virtues of deregulation and the deep-seated belief that Wall Street—guided by sophisticated quants from the Ivy League—can and should take care of itself without government meddling in its affairs was widespread among economists of various political persuasion.

That is not to say that economists influence all policy in Congress and Blinder gives a number of examples to the contrary, but that is hardly Madrick's main point. Rather, Madrick suggests that there are a number of crucial principles which are widely held and taught by economists that put their stamp on both popular culture and the *Weltanschauung* of the policy elite and these principles are both incorrect and hazardous to the health of the nation. Among these is the deep-seated but pernicious belief in the efficient workings of the invisible hand. There is no denying that the almost religious faith in the self-regulating mechanism of the market was held not only by the likes of Alan Greenspan and Phil Gramm but thanks to the economic profession became a defining characteristic of the *Zeitgeist* on Main Street.

The metaphor implies that the actions of selfish individuals will ultimately and inadvertently benefit society. However, Greenspan and the circa thousand economists working for the Fed simply forgot that the invisible hand does not work that way at all with imperfect information. I think that no one would argue today that Dick Fuld's or Angelo Mozilo's invisible hands benefited society; yet the metaphor lives on—in and out of classrooms in spite of Joseph Stiglitz's repeated warnings that the metaphor is no more than that and should not be taken seriously: "the reason the invisible hand often seemed invisible was that it was not there.... Markets by themselves do not lead to economic efficiency."[4]

Yet, Blinder challenges Madrick's characterization of the invisible hand by suggesting that "Throughout recorded history, there has never been a serious practical alternative to free competitive markets as a mechanism for delivering the right goods and services to the right people at the lowest possible costs. So it is essential that students learn about the virtues of the invisible hand in their first economics course." But what about those for whom the free market does not deliver enough of the "right goods and services" to meet even their basic needs? Blinder's mentality is precisely what Madrick is arguing against, inasmuch as this is the wrong way to teach economics. "Free competitive markets" have not existed for very long at any time anywhere, except on blackboards, because they are not stable forms of social organization and as importantly, certainly have absolutely nothing to do with today's real existing economic system dominated by giant oligopolies and too big to fail financial conglomerates with immense influence in the halls of Congress. In contrast to the markets in

Smith's time, the global marketplace today is rampant with systemic risk, opportunistic behavior, and asymmetric information that enables the strong to take advantage of the weak.

Blinder's use of the word "virtue" to refer to the invisible hand in this context is in itself a value judgment to which neither Madrick nor the inhabitants of some neighborhoods in the South Bronx—with a median income of $8,700—not per month, but per year—would easily subscribe.[5] In fact, Madrick argues that we should be instilling in our students from the outset that markets that are not well regulated are dangerous and that without sufficient countervailing power the invisible hand becomes an invisible fist that cruelly excludes a substantial portion of the population from a decent life. So Blinder's virtuous invisible hand should by no means be the default model taught to Princeton undergraduates; instead we need to stress that only with adequate oversight will markets provide equitable outcomes in a stable economy. And perhaps it would be best to forget about the invisible hand metaphor altogether; after all, as Stiglitz suggests it is an outdated metaphor for our time.

John Komlos
Chapel Hill, NC

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[1] Joseph Stiglitz Lecture "Freefall" at the Commonwealth Club of California, February 22, 2010. http://fora.tv/2010/02/22/Joseph_Stiglitz_Freefall Accessed December 18, 2014.

[2] John Komlos, *What Every Economics Student Needs to Know and Doesn't Get in the Usual Principles Text* (New York: M.E. Sharpe, 2014).

[3] Ben S. Bernanke, "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression," *American Economic Review*, June 1983, pp. 257-276; here p. 258.

[4] Joseph Stiglitz, "Doctor of Honoris Causa Ceremony Speech," University of the Basque Country, Bilbao, Spain, May 23, 2006. See also his Nobel Prize lecture: Joseph Stiglitz, "Information and the Change in the Paradigm in Economics," Stockholm University, Aula Magna, December 8, 2001.

[5] Arun Venugopal, "Census Pinpoints City's Wealthiest, Poorest Neighborhoods" WNYC News Thursday, December 08, 2011 http://www.wnyc.org/story/174508-blog-census-locates-citys-wealthiest-and-poorest-neighborhoods/ accessed August 31, 2014.