An Economic Uncertainty Principle

If you're so smart, why ain't you rich? It's a good question to keep in mind when watching infomercials about easy money in real estate and when listening to economists engage in learned predictions of GNP, interest rates or unemployment.

The most important discovery in economic science over the past 30 years is that this query, which I call the American Question, has no good answer. The early Latin poet Ennius sneered at forecasters "who don't know the path for themselves yet show the way for others." But only in recent decades have economists put principles and hard numbers behind this ancient observation.

It is rare that a scientific principle can make you money, but if I had learned the meaning of the American Question earlier and better, I would be $10,000 richer. It turns out that you, too, can get rich by learning it (or at least avoid losing money, which in economic terms amounts to the same thing).

The American Question is a siren of chutzpah. It's funny, but it's serious, too, and it cuts deep. See how it skews an economist who claims to predict next month's interest rate. Clearly, there is a fortune to be made with such knowledge: the price of interest-bearing securities such as bonds rises when rates fall, and vice versa. Knowing next month's interest rates is equivalent to knowing next month's bond prices. So why isn't the economist savant rich? Seriously, now. Keep quiet, get a second mortgage, buy bonds today, then sell them at a fat profit in a month. It's a sure thing.

Of course, a claim that the interest rate will fall next month is also a claim that the rest of the chumps in the market do not know this fact. If they did, the interest rate would have fallen already, and there would be no profit to be made buying bonds today. That pattern reflects how markets work when they get information about their future. Furthermore, there's no way around this conundrum: orders to buy or sell bonds convey information about each trader's beliefs regarding next month's interest rate. An economist with perfect foreknowledge would end up revealing it to everyone else in the market in short order.

The notion that exclusive information is dissipated by the very act of using it goes beyond financial markets. Anyone who has watched the electronics industry during the past 15 years can recall a dozen or more brilliant new ideas that seemed like a license to print money when only one company had thought of them: memory chips, video games, IBM PC clones, word-processing software. Then dozens of entrants jumped into the same niche, boldly assuming that 40 could enjoy the same profit margin as one. Often even the original innovators lost their shirts.

Economists are still discovering the full depth of the American Question—that is why even today some of them go around offering predictions about the price of bonds or the turning point of the business cycle. You can tell the history of the American Question by looking at the Nobel Prizes in Economics

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that were awarded for asking it. Friedrich A. von Hayek (1974) led the "Austrian" school of economics, which has been saying for a long time that if it were possible to outwit a society's judgment of what is profitable, social scientists would be rich. Merton M. Miller (1990) observed that if, in fact, the hot tips you stockbroker sells you had any value, then running the broker's little formulas for picking "incorrectly valued" stocks should make you rich. Statistics show that it ain't so.

Robert Lucas (put your money on 1998) has pointed out that the American Question could also be asked of governments trying to fool some of the people some of the time. Lucas's work with Thomas Sargent and others is called rational expectations, a phrase with enough arrogance and mystery to be controversial. But Lucas would agree that at bottom he is asking the same goofy old question: If the deep thinkers at the Federal Reserve Board can outguess the public, Lucas asks, whyaren't they rich? Or, at the very least, why isn't the government solvent?

Paul A. Samuelson (1970)—who is rich, thank you—did not get the Nobel Prize for asking the Question. But he has held all along, as he put it in 1982, that "it's a mug's game for a dentist—or an associate professor of econometrics—to think that he can have an edge over those who count the cocoa pods in Africa and follow the minute-by-minute arrival of new information."

The Question is beginning to constrain economic argument the way Heisenberg constrains quantum mechanics or Gödel constrains mathematical logic. In all probability, you cannot understand a social fact and make money from it at the same time. And if you could, the market would adapt to render your understanding invalid. (The economic statistics that were once used to predict recessions, for example, now predict instead when the government will make policy changes intended to ward off recessions.)

So here is the practical use of this deep scientific principle. Fire your stockbroker the instant he says that Fly-by-Nite Canadian Gold Mining Ltd. is "undervalued" or that "we're recommending" Whitewater Real Estate, Inc. Or, to take my own sad case, do not believe your brilliant former student at the University of Chicago when he comes up with a scheme, in which other economists have invested, to make money out of a glitch in the foreign-exchange market. On that one I lost half my $10,000 in a weekend.

So be smart and rich. Do what I say, not what I do. Constrain economic science with the American Question, and if someone offers you a tip, ask yourself why they are not using it themselves. As a Damon Runyon character said, "Now, Herbie, I do not doubt your information, because I know you will not give out information unless it is well founded. But I seldom stand for a tip.... So I thank you, Herbie, just the same, but I must do without your tip."

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