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BOOK REVIEW

“The undoing project: a friendship that changed our minds”

By Michael Lewis, Norton Press, 2016

Ellen Hughes-Cromwick[1]

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That an economist could review this work of art with unwavering objectivity may be too much to ask. Note to reader up front: The work of two psychologists about people’s decision-making behavior outshines some of the best in our own profession who tried to crack the code. The economics profession grudgingly reformed with a revived branch of thought called behavioral economics, but our best and brightest were led there by two mental wizards—Danny Kahneman and Amos Tversky.

Michael Lewis tells the story of these two psychologists who upended many economic theoretical tenets about behavior and individual decision-making. Lewis reportedly spent eight years cultivating the framing of two intertwined melodies: The soprano rhythm of the creation of new, tested ideas about choice, set against the baritone voice of deep friendship and collaboration.

Let’s start with the soprano lead. Most economics students start in microeconomics 101 with a flyover on the theory of consumer behavior. Students are taught that consumers are rational, with their decisions based on data, evidence, and that “more is better than less,” which is shorthand for the principle of maximizing individual welfare. People make informed decisions and behave “as if” there is a big data microprocessor embedded in the brain’s cortex.

As psychologists steeped in statistical methods, Kahneman and Tversky were skeptical of this rationality, and over the course of many experiments and extensive collaboration, they advanced our understanding of how people truly make decisions with incomplete information. The answer: often without full use of our brain and what conventional economists attribute to us as stealthily honed statistical skills and raw logic without emotion. Or rather, economists staked out optimal behavior while Kahneman and Tversky modeled how we really, truly make choices.

One of the passionate crescendos in the book is the duo’s magnificent work explaining rules of prediction. Starting in the early 1970s, Kahneman and Tversky huddled and came up with several assertions which they believed accurately reflected the way the world really works. Here is a sampling:

People predict by making up stories
People predict very little and explain everything
People believe they can tell the future if they work hard enough
People often work hard to obtain information they already have and avoid new knowledge.

Through a series of experiments with their Oregon students, they illustrated that there is an inherent inclination to make predictions based more on gut feeling and less on objective data (pp. 196–201).

The voices of the soprano become elevated and joyous as the duo expand and deepen their work on how we make judgments as human beings when we are confronted with much uncertainty—work that has many strands applicable to the world in which we live. Was Brexit truly a miscalculation by many? Did they understand the forecast they were making when they voted to separate from the EU? We don’t enjoy recognizing this voice of uncertainty in our lives. We can’t trust ourselves—judgment calls can be fake. Uncertainty is ever present in our professional lives as economists. We the so-called “experts” are making

✉ Ellen Hughes-Cromwick
e.hughescromwick@gmail.com

[1] University of Michigan Energy Institute, Ann Arbor, MI, USA

forecasts, drawing up judgments while surfing on a wave of uncertainty, and who among us wants to admit mistakes.

How did these psychologists "prove" the biases we have in making judgments in an uncertain world? There is a compelling example on page 226. "Given a choice between a sure gain and a bet with the same expected value (say, $100 for sure or a 50–50 shot at winning $200)…people tended to take the sure thing. But given the choice between a *sure loss* (emphasis added) of $100 and a 50–50 shot at losing $200, people took the risk." Same odds, different choices due to the framing and our aversion to loss.

Lewis takes us on a journey through our own minds as he weaves together the duo's research on how we make decisions, and how we deal with the uncomfortable conditions of risk and uncertainty.

A pivoting point is the chapter entitled, "Rules of Undoing." Lewis opens for us a quixotic portal into the unusually close collaboration of Kahneman and Tversky. You will enjoy the rapture of thought, the intimacy of the partnership and its eventual demise. As academic appointments at different universities expunges their daily intimacy, Kahneman begins to pursue independently his interest in understanding imagination. When an event takes place, particularly a surprising and unexpected one, how do we imagine a different outcome, an "alternative reality?" The implication is that such imagination of alternative outcomes would better inform our predictions of the future by entertaining the consequences of an unexpected event. He found that our imaginations obey "rules of undoing."

Now to the baritone voice of love. A sweet and subtle, yet vexing story of professional collaboration, of love, deep love. A divorce ensues as geographic distance separates Kahneman and Tversky, but the roots of the divide are in fundamental emotions of envy, jealousy, and sorrow. Kahneman's effervescence toward his new research on the "Undoing Project" was a turning point and indeed, the beginning of the end of a sweet baritone hymn which lasted nearly a decade. Living, breathing, laughing, creating, and inventing a new way of understanding thinking, judgment and choice—the creativity of imagination.

As economists, we may be put off by such an approach to our quantitatively wired "science." You may be disappointed that Lewis does not pull a bit more on the strings regarding the discovery of important economic choice building blocks not by economists but psychologists. Perhaps microeconomists reading this book will have a different reaction, but as a macroeconomist, the critique of "expertise" may deserve yet another book. Many of us may profess to acknowledge the range of uncertainties confronting us as we make forecasts, and yet, we supply our projections with a fine point, like a 2.1% real GDP growth for 2017. The certainty that this precision conveys is a falsehood, *a charade*. Other examples are relevant and timely, such as predicting the timing of the next recession. One lesson from reading this book is to resolve again to be humble in forecasting, to not issue an "alternative reality" of certainty.

While Lewis acknowledges the great work of Richard Thaler, connecting this story back to the outstanding 2016 American Economic Association Presidential Address that he gave would have added an important dimension. After all, without the work of Thaler, we would not be on the cusp of mainstreaming explanations of human behavior which contradict the traditional economic model, the one where people have well-defined preferences, unbiased beliefs and expectations, and who make optimal decisions.

Read the book and let your imagination run on the current political economy and develop your own experiments in "undoing" toward reality. I found it to be good therapy for coping with and understanding today's political economy!

Working as the chief economist of Ford Motor Company during the global financial crisis provided an experience which tested many of the underpinnings of behavioral economics. One of the important tools we deployed was referred to as "base, opps, and risks." Given the substantial uncertainty in the global economic environment, our team worked hard to develop the baseline assumptions regarding demand conditions, pricing, interest rates, and exchange rates. But stopping there would have been worthless. In order to run the business, our leaders needed to understand risk and opportunity dimensions and how we framed these attributes in the forecast.

The process of establishing probabilities was part quantitative and part qualitative. This is where the team's interactions in diverse team groups really paid off. We engaged in discussions with members of the finance and treasury teams, members of product development and marketing and sales, and with our policy and government relations experts. Without this dialogue and consensus building, we would have been in a failure mode. We knew that a pure economic model would have provided a false sense of security. Point forecasts don't describe the global economy.

I hope you enjoy the book—let it either reinforce or change your thinking, in a humble way!

Ellen Hughes-Cromwick is currently Interim Associate Director of Social Science and Policy as well as Senior Economist at the University of Michigan Energy Institute.