

## Arrow, Kenneth

Most financial decisions are made under conditions of uncertainty. Yet a formal analysis of markets under uncertainty emerged only recently, in the 1950s. The matter is complex as it involves explaining how individuals make decisions when facing uncertain situations, the behavior of market instruments such as insurance, securities, and their prices, the welfare properties of the distribution of goods and services under uncertainty, and how risks are shared among the traders. It is not even obvious how to formulate market clearing under conditions of uncertainty. A popular view in the middle of the last century was that markets would only clear on the average and asymptotically in large economies.<sup>a</sup> This approach was a reflection of how insurance markets work, and followed a notion of actuarially fair trading.

A different formulation was proposed in the early 1950s by Arrow and Debreu [10, 12, 30]. They introduced an economic theory of markets in which the treatment of uncertainty follows basic principles of physics. The contribution of Arrow and Debreu is as fundamental as it is surprising. For Arrow and Debreu, markets under uncertainty are formally identical to markets without uncertainty. In their approach, uncertainty all but disappears.<sup>b</sup>

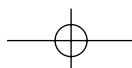
It may seem curious to explain trade with uncertainty as though uncertainty did not matter. The disappearing act of the issue at stake is an unusual way to think about financial risk, and how we trade when facing such risks. But the insight is valuable. Arrow and Debreu produced a rigorous, consistent, general theory of markets under uncertainty that inherits the most important properties of markets without uncertainty. In doing so, they forced us to clarify what is intrinsically different about uncertainty.

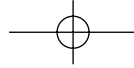
This article summarizes the theory of markets under uncertainty that Arrow and Debreu created, including critical issues that arise from it, and also its legacy. It focuses on the way Arrow introduced securities: how he defined them and the limits of his theory. It mentions the theory of insurance that Arrow pioneered together with Malinvaud and others [6], as well as the theory of risk bearing that Arrow developed on the basis of expected utility [7], following the axioms of Von Neumann and Morgenstern [41], Hirschman and Milnor [33], De Groot [31], and Villegas [40]. The legacy of

Arrow's work is very extensive and some of it surprising. This article describes his legacy along three lines: (i) individual and idiosyncratic risks, (ii) rare risks and catastrophic events, and (iii) endogenous uncertainty.

### Biographical Background

Kenneth Joseph Arrow is American economist and joint winner of the Nobel Memorial Prize in Economics with John Hicks in 1972. Arrow taught at Stanford University and Harvard University. He is one of the founders of modern (post World War II) economic theory, and one of the most important economists of the twentieth century. For a full biographical note, the reader is referred to [18]. Born in 1921 in New York City to Harry and Lilian Arrow, Kenneth was raised in the city. He graduated from Townsend Harris High School and earned a bachelor's degree from the City College of New York studying under Alfred Tarski. After graduating in 1940, he went to Columbia University and after a hiatus caused by World War II, when he served with the Weather Division of the Army Air Forces, he returned to Columbia University to study under the great statistician Harold Hotelling at Columbia University. He received a master's degree in 1941 studying under A. Wald, who was the supervisor of his master's thesis on stochastic processes. From 1946 to 1949 he spent his time partly as a graduate student at Columbia and partly as a research associate at the Cowles Commission for Research in Economics at the University of Chicago; it was in Chicago that he met his wife Selma Schweitzer. During that time, he also held the position of Assistant Professor of Economics at the University of Chicago. Initially interested in following a career as an actuary, in 1951 he earned his doctorate in economics from Columbia University working under the supervision of Harold Hotelling and Albert Hart. His published work on risk started in 1951 [3]. In developing his own approach to risk, Arrow grapples with the ideas of Shackle [39], Knight [35], and Keynes [34] among others, seeking and not always finding a rigorous mathematical foundation. His best-known works on financial markets date back to 1953 [3]. These works provide a solid foundation based on the role of securities in the allocation of risks [4, 5, 7, 9, 10]. His approach can be described as a state contingent security approach to





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the allocations of risks in an economy, and is largely an extension of the same approach he followed in his work on general equilibrium theory with Gerard Debreu, for which he was awarded the Nobel Prize in 1972 [8]. Nevertheless, his work connects also with social issues of risk allocation and with the French literature of the time, especially [1, 2].

### Markets under Uncertainty

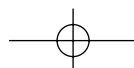
The Arrow–Debreu theory conceptualizes uncertainty with a number of possible states of the world  $s = 1, 2, \dots$  that may occur. Commodities can be in one of several states, and are traded separately on each of the states of nature. In this theory, one does not trade a good, but a “contingent good”, namely, a good in each state of the world: apples when it rains and apples when it shines [10, 12, 30]. This way the theory of markets with  $N$  goods and  $S$  states of nature is formally identical to the theory of markets without uncertainty but with  $N \times S$  commodities. Traders trade “state contingent commodities”. This simple formulation allows one to apply the results of the theory of markets without uncertainty, to markets with uncertainty. One recovers most of the important results such as (i) the existence of a market equilibrium and (ii) the “invisible hand theorem” that establishes that market solutions are always Pareto efficient. The approach is elegant, simple, and general.

Along with its elegance and simplicity, the formulation of this theory can be unexpectedly demanding. It requires that we all agree on all the possible states of the world that describe “collective uncertainty”, and that we trade accordingly. This turns out to be more demanding than it seems: for example, one may need to have a separate market for apples when it rains than when it does not, and separate market prices for each case. The assumption requires  $N \times S$  markets to guarantee market efficiency, a requirement that in some cases militates against the applicability of the theory. In a later article, Arrow simplified the demands of the theory and reduced the number of markets needed for efficiency by defining “securities”, which are different payments of money exchanged among the traders in different states of nature [4, 5]. This new approach no longer requires trading “contingent” commodities but rather trading a combination of commodities and securities. Arrow

proves that by trading commodities and securities, one can achieve the same results as trading state contingent commodities [4, 5]. Rather than needing  $N \times S$  markets, one needs a fewer number of markets, namely,  $N$  markets for commodities and  $S - 1$  markets for securities. This approach was a great improvement and led to the study of securities in a rigorous and productive manner, an area in which his work has left a large legacy. The mathematical requirement to reach Pareto efficiency was simplified gradually to require that the securities traded should provide for each trader a set of choices with the same dimension as the original state contingent commodity approach. When this condition is not satisfied, the markets are called “incomplete”. This led to a large literature on incomplete markets, for example, [26, 32], in which Pareto efficiency is not assured, and government intervention may be required, an area that exceeds the scope of this article.

### Individual Risk and Insurance

The Arrow–Debreu theory is not equally well suited for all types of risks. In some cases, it could require an unrealistically large number of markets to reach efficient allocations. A clear example of this phenomenon arises for those risks that pertain to one individual at a time, called *individual risks*, which are not readily interpreted as states of the world on which we all agree and are willing to trade. Individuals’ accidents, illnesses, deaths, and defaults, are frequent and important risks that fall under this category. Arrow [6] and Malinvaud [37] showed how individual uncertainty can be reformulated or reinterpreted as collective uncertainty. Malinvaud formalized the creation of states of collective risks from individual risks, by lists that describe all individuals in the economy, each in one state of individual risk. The theory of markets can be reinterpreted accordingly [14, 37, 38], yet remains somewhat awkward. The process of trading under individual risk using the Arrow–Debreu theory requires an unrealistically large number of markets. For example with  $N$  individuals, each in one of two individual states  $G$  (good) and  $B$  (bad), the number of (collective) states that are required to apply the Arrow–Debreu theory is  $S = 2^N$ . The number of markets required is as above, either  $S \times N$  or  $N + S - 1$ . But with  $N = 300$  million people, as in the US economy,



applying the Arrow–Debreu approach would require  $N \times S = N \times 2^{300 \text{ million}}$  markets to achieve Pareto efficiency, more markets than the total amount of particles in the known universe [25]. For this reason, individual uncertainty is best treated with another formulation of uncertainty involving individual states of uncertainty and insurance rather than securities, in which market clearing is defined on the average and may never actually occur. In this new approach, instead of requiring  $N + S - 1$  markets, one requires only  $N$  commodity markets and, with two states of individual risk, just one security: an insurance contract suffices to obtain asymptotic efficiency [37, 38]. This is a satisfactory theory of individual risk and insurance, but it leads only to asymptotic market clearing and Pareto efficiency. More recently, the theory was improved and it was shown that one can obtain exact market-clearing solutions and Pareto-efficient allocations based on  $N$  commodity markets with the introduction of a limited number of financial instruments called *mutual insurance* [14]. It is shown in [14] that if there are  $N$  households (consisting of  $H$  types), each facing the possibility of being in  $S$  individual states together with  $T$  collective states, then ensuring Pareto optimality requires only  $H(S - 1)T$  independent mutual insurance policies plus  $T$  pure Arrow securities.

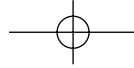
### Choice and Risk Bearing

Choice under uncertainty explains how individuals rank risky outcomes. In describing how we rank choices under uncertainty, one follows principles that were established to describe the way nature ranks what is most likely to occur, a topic that was widely explored and is at the foundation of statistics [31, 40]. To explain how individuals choose under conditions of uncertainty, Arrow used behavioral axioms that were introduced by Von Neumann and Morgenstern [41] for the theory of games<sup>c</sup> and axioms defined by De Groot [31] and Villegas [40] for the foundation of statistics. The main result obtained in the middle of the twentieth century was that under rather simple behavioral assumptions, individuals behave as though they were optimizing an “expected utility function”. This means that they behave as though they have (i) a utility  $u$  for commodities, which is independent of the state of

nature, and (ii) subjective probabilities about how likely are the various states of nature. Using the classic axioms one constructs a ranking of choice under uncertainty obtaining a well-known expected utility approach. Specifically, traders choose over “lotteries” that achieve different outcomes in different states of nature. When states of nature and outcomes are represented by real numbers in  $R$ , a lottery is a function  $f : R \rightarrow R^N$ , a utility is a function  $u : R^N \rightarrow R$ , and a subjective probability is  $p : R \rightarrow [0, 1]$  with  $\int_R p(s) = 1$ . Von Neumann, Arrow, and Hershstein and Milnor, all obtained the same classic “representation theorem” that identifies choice under uncertainty by the ranking of lotteries according to a real-valued function  $W$ , where  $W$  has the now familiar “expected utility” form:

$$W(f) = \int_{s \in R} p(s) \cdot u(f(s)) \, ds \quad (1)$$

The utility function  $u$  is typically bounded to avoid paradoxical behavior. The expected utility approach just described has been generally used since the mid-twentieth century. Despite its elegance and appeal, from the very beginning, expected utility has been unable to explain a host of experimental evidence that was reported in the work of Allais [2] and others. There has been a persistent conflict between theory and observed behavior, but no axiomatic foundation to replace Von Neumann’s foundational approach. The reason for this discrepancy has been identified more recently, and it is attributed to the fact that expected utility is dominated by frequent events and neglects rare events—even those that are potentially catastrophic, such as widespread default in today’s economies. That expected utility neglects rare events was shown in [17, 19, 23]. In [23], the problem was traced back to Arrow’s axiom of monotone continuity [7], which Arrow attributed to Villegas [40], and to the corresponding continuity axioms of Hershstein and Milnor, and De Groot [31], who defined a related continuity condition denoted “ $SP_4$ ”. Because of this property, on which Arrow’s work is based, the expected utility approach has been characterized as the “dictatorship” of frequent events, since it is dominated by the consideration of “normal” and frequent events [19]. To correct this bias, and to represent more accurately how we choose under uncertainty, and to arrive at a more realistic meaning of rationality, a new axiom was added in [17, 19, 21], requiring equal treatment for frequent



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and for rare events. The new axiom was subsequently proven to be the logic negation of Arrow's monotone continuity that was shown to neglect small probability events [23].

The new axioms led to a "representation theorem" according to which the ranking of lotteries is a modified expected utility formula

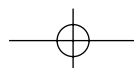
$$W(f) = \int_{s \in R} p(s) \cdot u(f(s)) ds + \phi(f) \quad (2)$$

where  $\phi$  is a continuous linear function on lotteries defined by a finite additive measure, rather than a countably additive measure [17, 19]. This measure assigns most weight to rare events. The new formulation has both types of measures, so the new characterization of choice under uncertainty incorporates both (i) frequent and (ii) rare events in a balanced manner, conforming more closely to the experimental evidence on how humans choose under uncertainty Chanel [15]. The new specification gives well-deserved importance to catastrophic risks, and a special role to fear in decision making [23], leading to a more realistic theory of choice under uncertainty and foundations of statistics, [15, 23, 24]. The legacy of Kenneth Arrow's work is surprising but strong: the new theory of choice under uncertainty coincides with the old when there are no catastrophic risks so that, in reality, the latter is an extension of the former to incorporate rare events. Some of the most interesting applications are to environmental risks such as global warming [25]. Here Kenneth Arrow's work was prescient: Arrow was an early contributor to the early literature on environmental risks and irreversibilities [11], along with option values.

#### Endogenous Uncertainty and Widespread Default

Some of the risks we face are not created by nature. They are our own creation, such as global warming or the financial crisis of 2008 and 2009 anticipated in [27]. In physics, the realization that the observer matters, that the observer is a participant and creates uncertainty, is called *Heisenberger's uncertainty principle*. The equivalent in economics is an uncertainty principle that describes how we create risks through our economic behavior. This realization led to the new concept of "markets with endogenous uncertainty", created in 1991, and embodied in early

articles [16, 27, 28] that established some of the basic principles and welfare theorems in markets with endogenous uncertainty. This, and other later articles ([20, 25, 27, 36]), established basic principles of existence and the properties of the general equilibrium of markets with endogenous uncertainty. It is possible to extend the Arrow–Debreu theory of markets to encompass markets with endogenous uncertainty and also to prove the existence of market equilibrium under these conditions [20]. But in the new formulation, Heisenberg's uncertainty principle rears its quizzical face. It is shown that it is no longer possible to fully hedge the risks that we create ourselves [16], no matter how many financial instruments we create. The equivalent of Russel's paradox in mathematical logic appears also in this context due to the self-referential aspects of endogenous uncertainty [16, 20]. Pareto efficiency of equilibrium can no longer be ensured. Some of the worst economic risks we face are endogenously determined—for example, those that led to the 2008–2009 global financial crisis [27]. In [27] it was shown that the creation of financial instruments to hedge individual risks—such as credit default insurance that are often a subject of discussion in today's financial turmoil—by themselves induce collective risks of widespread default. The widespread default that we experience today was anticipated in [27], in 1991, and in 2006, when it was attributed to endogenous uncertainty created by financial innovation as well as to our choices of regulation or deregulation of financial instruments. Examples are the extent of reserves that are required for investment banking operations, and the creation of mortgage-backed securities that are behind many of the default risks that faced today [29]. Financial innovation of this nature, and the attendant regulation of new financial instruments, causes welfare gains for individuals—but at the same time creates new risks for society that bears the collective risks that ensue, as observed in 2008 and 2009. In this context, an extension of the Arrow–Debreu theory of markets can no longer treat markets with endogenous uncertainty as equivalent to markets with standard commodities. The symmetry of markets with and without uncertainty is now broken. We face a brave new world of financial innovation and the endogenous uncertainty that we create ourselves. Creation and hedging of risks are closely linked, and endogenous uncertainty has acquired a critical role in market performance and economic welfare, an issue



that Kenneth Arrow has more recently tackled himself through joint work with Frank Hahn [13].

### Acknowledgments

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### End Notes

<sup>a</sup>See [37, 38]; later on Werner Hildenbrand followed this approach.

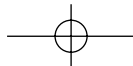
<sup>b</sup>They achieved the same for their treatment of economic dynamics. Trading over time and under conditions of uncertainty characterizes financial markets.

<sup>c</sup>And similar axioms used by Heston and Milnor [33].

<sup>d</sup>Specifically to avoid the so-called St. Petersburg paradox, see [7].

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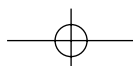
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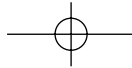
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**Abstract:** This article summarizes the theory of markets under uncertainty, developed by Arrow and Debreu. It describes the achievements of the theory, the critical issues that it raises, and its large legacy. This article also focuses on the way Arrow introduced securities: how he defined them and what were the most useful developments of this theory. It mentions the theory of insurance that Arrow pioneered together with Malinvaud and others, and Arrow's theory of risk bearing that follows the axiomatic treatment of Von Neumann and Morgenstern, Milnor, Harsanyi, De Groot, and Villegas. In terms of Arrow's legacy, it is now known that the classic expected utility theory embraces normal or frequent risks at the expense of neglecting rare events, even those with important consequences such as catastrophes, causing paradoxical experimental behavior. Kenneth Arrow encouraged the creation of a more recent extension of classic axiomatic theory of choice under uncertainty, and, in the early 1990s, we proposed axioms that treat symmetrically frequent and rare events, leading to a new definition of rationality and of choices under uncertainty that conform better to the experimental evidence. The introduction of markets with "endogenous uncertainty" in the early 1990s extended and challenged the foundation of the Arrow–Debreu theory of markets by considering risks that are created by the workings of the economy, resulting in the breakdown of the equivalence between markets with and without uncertainty that prevails in the Arrow–Debreu theory. This led to a new world of uncertainty creation through financial innovation and regulation that is at the heart of the financial markets turmoil of 2008–2009. In 1999, Arrow himself contributed to the theory of endogenous uncertainty in his work with Frank Hahn.

**Keywords:** markets under uncertainty; securities; individual risk; collective risks; insurance; endogenous uncertainty; catastrophic risks; default; rare events; asset-backed securities

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