Why did economists not foresee the crisis?

Raghuram Rajan

February 7, 2011 – *Project Syndicate*

CHICAGO – At the height of the financial crisis, the Queen of England asked my friends at the London School of Economics a simple question, but one for which there is no easy answer: Why did academic economists fail to foresee the crisis?

Several responses to that query exist. One is that economists lacked models that could account for the behavior that led to the crisis. Another is that economists were blinkered by an ideology according to which a free and unfettered market could do no wrong. Finally, an answer that is gaining ground is that the system bribed economists to stay silent.

In my view, the truth lies elsewhere.

It is not true that we academics did not have useful models to explain what happened. If you believe that the crisis was caused by a shortage of liquidity, we had plenty of models analyzing liquidity shortages and their effects on financial institutions. If you believe that the blame lies with greedy bankers and unthinking investors, lulled by the promise of a government bailout, or with a market driven crazy by irrational exuberance, we had studied all this too, in great detail.

Economists even analyzed the political economy of regulation and deregulation, so we could have understood why some US politicians pushed the private sector into financing affordable housing, while others deregulated private finance. Yet, somehow, we did not bring all this understanding to bear and collectively shout our warnings.

Perhaps the reason *was* ideology: we were too wedded to the idea that markets are efficient, market participants are rational, and high prices are justified by economic fundamentals. But some of this criticism of "market fundamentalism" reflects a misunderstanding. The dominant "efficient markets theory" says only that markets reflect what is publicly known, and that it is hard to make money off markets consistently – something verified by the hit that most investor portfolios took in the crisis. The theory does not say that markets cannot plummet if the news is bad, or if investors become risk-averse.

Critics argue that the fundamentals were deteriorating in plain sight, and that the market (and economists) ignored it. But hindsight distorts analysis. We cannot point to a lonely Cassandra like Robert Shiller of Yale University, who regularly argued that house prices were unsustainable, as proof that the truth was ignored. There are always naysayers, and they are often wrong. There were many more economists who believed that house prices, though high, were unlikely to fall across the board.

Of course, these expectations could have been distorted by ideology – it is hard to get into the past minds of economists. But there is a better reason to be skeptical of explanations relying on ideology. As a group, neither behavioral economists, who think that market efficiency is a joke, nor progressive economists, who distrust free markets, predicted the crisis.

Could it be corruption? Some academic economists consult for banks or rating agencies, give speeches to investor conferences, serve as expert witnesses, and carry out sponsored research. It would be natural to suspect us of bias. The bias could be implicit: our worldview is shaped by what our friends in industry believe. Or it may be an explicit bias: an economist might write a report that is influenced by what a sponsor wants to hear, or give testimony that is purely mercenary.

There are enough instances of possible bias that the issue cannot be ignored. One remedy would be to ban all interaction between economists and the corporate world. But if economists were confined to the ivory tower, we might be unbiased, but we would also be ignorant of practicalities – and thus even less capable of predicting problems. One way to restore trust may be disclosure – for economists to declare a monetary interest in a particular analysis and, more generally, to explain who pays us. A number of universities are moving in this direction.

But I believe that corruption is not the main reason that the profession missed the crisis. Most economists have very little interaction with the corporate world, and these "unbiased" economists were no better at forecasting the crisis.

I would argue that three factors largely explain our collective failure: specialization, the difficulty of forecasting, and the disengagement of much of the profession from the real world.

Like medicine, economics has become highly compartmentalized – macroeconomists typically do not pay attention to what financial economists or real-estate economists study, and *vice versa*. Yet, to see the crisis coming would have required someone who knew about each of these areas – just as it takes a good general practitioner to recognize an exotic disease. Because the profession rewards only careful, well-supported, but necessarily narrow analysis, few economists try to span sub-fields.

Even if they did, they would shy away from forecasting. The main advantage that academic economists have over professional forecasters may be their greater awareness of established relationships between factors. What is hardest to forecast, though, are turning points – when the old relationships break down. While there may be some factors that signal turning points – a run-up in short-term leverage and asset prices, for example, often presages a bust – they are not infallible predictors of trouble to come.

The meager professional rewards for breadth, coupled with the inaccuracy and reputational risk associated with forecasting, leads to disengagement for most academics. And it may well be that academic economists have little to say about short-term economic movements, so that forecasting, with all its errors, is best left to professional forecasters.

The danger is that disengagement from short-term developments leads academic economists to ignore medium-term trends that they *can* address. If so, the true reason why academics missed the crisis could be far more mundane than inadequate models, ideological blindness, or corruption, and thus far more worrisome; many simply were not paying attention!

Raghuram Rajan is Professor of Finance at the Booth School of Business, University of Chicago, and author of Fault Lines: How Hidden Fractures Still Threaten the World Economy.