 AFTER THE BLOWUP

Laissez-faire economists do some soul-searching—and finger-pointing.

BY JOHN CASSIDY

Some visitors to the Everett M. Dirksen United States Courthouse, in downtown Chicago, come in search of justice, others for a birthday, or to get their hair cut. After passing security and riding the elevator to the twenty-seventh floor, I was shown into the chambers of Judge Richard A. Posner, the famously prolific jurist, law professor, author, and, lately, blogger, who for decades has been a leading light in the conservative Chicago School of economics. Arranging his thin frame on a leather sofa that afforded him a gull-eye view of Lake Michigan, Posner held forth on the global economic slump that began in 2007, and the failure of many economists to foresee it. In a soft voice, he said, “I think the challenge is to the economics profession as a whole, but to Chicago most of all.”

A lawyer by training, Posner is also one of the country’s most influential economics writers. In his 1973 treatise “Economic Analysis of Law,” he applied the maxims of free-market economics to the courtroom, arguing that enforcing economic efficiency ought to be a primary goal of judges. Posner, who was then a young professor at the University of Chicago Law School, helped create the law-and-economics movement, which has populated many of America’s courts with judges of similar mind. In 1981, Ronald Reagan nominated him to the Seventh Circuit Court of Appeals, and since then he has written more than a dozen books, including one defending the 2000 Supreme Court decision that gave George W. Bush the Presidency.

Earlier this year, Posner published “A Failure of Capitalism,” in which he argues that lax monetary policy and deregulation helped bring on the current slump. “We are learning from it that we need a more active and intelligent government to keep our model of a capitalist economy from running off the rails,” Posner writes. “The movement to deregulate the financial industry went too far by exaggerating the resilience—the self-healing powers—of laissez-faire capitalism.” Posner also accuses professional economists, including some of his Chicago colleagues, of being “asleep at the switch.” In September, he came out as a Keynesian; in a long piece in The New Republic, he hailed “The General Theory of Employment, Interest, and Money,” which John Maynard Keynes published in 1936, as a “masterpiece,” saying that “despite its antiquity, it is the best guide we have to the crisis.”

As acts of betrayal go, this was roughly akin to Johnny Damon’s shaving off his beard, forsaking the Red Sox Nation, and joining the Yankees. Ever since Milton Friedman, George Stigler, and others founded the Chicago School, in the nineteen-thirties and fourties, one of its goals has been to replace Keynesianism, and it had largely succeeded. For three decades after the Second World War, economics was dominated by Keynesian ideas about how the government should use monetary and fiscal policy to prevent slumps. Since 1974, however, more than a dozen scholars, associated with the U. C. have been awarded the Nobel Memorial Prize in Economic Sciences; in the areas of regulation, trade, anti-trust law, taxes, interest rates, and welfare, Chicago thinking greatly influenced policymaking in the United States and many other parts of the world. Keynesianism appeared to have consigned to history.

But in the year after the crash Keynes’s name appeared to be everywhere, several books were published about him, and policymakers again embraced his ideas. Until the banking crisis erupted, Posner hadn’t bothered to investigate “The General Theory.” When he picked it up, he was greatly impressed by the economic insights and practical detail it contained. “Even though it is kind of loose—it doesn’t do all the ‘ifs’ and cross all the ‘es’, Keynesian economics “seems to have more of a grasp of what is going on in the economy,” Posner said to me. Much of modern economics, by contrast, is “on the one hand, very mathematical, and, on the other hand, very . . . credulous about the self-regulating power of markets. That combination is dangerous. In “A Failure of Capitalism,” Posner singles out several economists, including Robert Lucas, one of Friedman’s most eminent successors, and John Cochrane, another prominent Chicago economist, for failing to appreciate the magnitude of the subprime crisis. During our conversations, Posner questioned the effectiveness of the business cycle methodology that Lucas and his colleagues pioneered. Its basic notions were the efficient-markets hypothesis, which says that the prices of stocks and other financial assets accurately reflect all the available information about economic fundamentals, and the rational-expectations theory, which posits that individuals and firms are hyper-intelligent decision-makers who have a correct model of the economy in their heads. In rational-expectations theory, the economy is represented in very simplified and spare fashion. Many models, including some relied on by the Fed and other central banks, don’t even feature banks or other financial intermediaries. In Posner’s view, older, less dogmatic theories better explained how the problems in the financial sector dragged down the rest of the economy. Of course, you have to know a lot about banking, and that was not the case with economists,” he said. “Odd, in a way, because macroeconomists and finance theorists have always been interested in banking, but I don’t think they really understood a lot about it.”

Although Posner was unavailingly polite, I detected an edge of anger in his comments about the economics profession and its embrace of such patently unrealistic theories. I asked what he thought economists had learned from the past two years. “Well, one possibility is that they have learned nothing,” he replied slowly. “Because—how should I put it—because market correctness work very slowly in dealing with academic markets. Professors have tenure. They have lots of graduate students in the pipeline who need to get their Ph.D.s. They have techniques that they know and are comfortable with. It takes a great deal to drive them out of their accustomed way of doing business.”

After leaving Posner’s office, I drove south to the University of Chicago’s Hyde Park campus, which for more than half a century has been a thriving hub of conservative thought and disputation, housing thinkers as diverse as Leo Strauss and acolytes in political philosophy, Albert Wohlstetter and his fellow Cold Warriors in nuclear strategy, and Posner, Richard Epstein, and others in law. The archetypal Chicago intellectual—embodied by Ravelstein, the chain-smoking professor of political philosophy who appears in Saul Bellow’s 2000 novel of the same name—has combined an interest in big ideas with urgent engagement in current affairs. Last fall, as the financial crisis intensified, many Chicago economists halted their own research to concentrate on the moment. “Everybody here was blindsided by the magnitude of what happened,” James Heckman, whose work on labor economics and statistics won him a share of the 2000 Nobel Prize, told me. “But it wasn’t just here. The entire profession was blindsided.” Conferences were organized, seminars were held, and faculty lunchrooms were full of vigorous debate. One panel session at which half a dozen prominent Chicago economists discussed “The Future of Markets” drew more than a thousand people to a Shaker downtown. “Everybody got involved,” Eugene Fama, a veteran finance specialist at the university’s Booth School of Business, said. “ Everybody’s got a cure. I don’t trust any of their prescriptions.”

In the course of a few days, I talked to economists from various branches of the subject. The over- all reaction I encountered...
Berndt put me in mind of what happened to cosmeticsology. Edwin Hubble, in 1929, discovered that the universe was expanding, and was much larger than scientists believed. The≪Hubble≫ law led to some new insights into the universe, which posited a stable universe. Others, Albert Einstein included, tried to adapt the old models to Hubble's data. Still others attempted to come up with a new account of how the galaxies formed; it was this effort that ultimately produced the theory of the big bang.

Fama, whom I interviewed in his office at the Booth School, was firmly in the denial camp. A short, wry man of seventy, with cropped hair and wearing a short-sleeved flowered shirt, he looked more like a retired marine in Miami Beach than like one of the founders of modern finance. Beginning in the nineteen-sixties and seventies, Fama, who holds the title of Robert R. McCormick Distinguished Service Professor of Finance, propounded the efficient-markets hypothesis, which underpinned the deregulation of the banking system championed by Alan Greenspan and others. I asked him how this theory had fared in the recent crisis, which many, myself included, have described as an example of gross inefficiency. Fama was unfazed. "I think it did quite well in this episode," he said, "because of his native Boston audience in his voice. "Stock prices typically decline prior to a recession and in a state of recession. This was a particularly severe recession. Prices started to decline in advance of when people recognized that it was a recession and then continued to decline. That was exactly what you would expect if markets are efficient."

The emphasis that Fama placed on the stock market surprised me. Surely, I said, we had experienced a giant credit bubble, which eventually burst. "I don't know what a credit bubble means," Fama replied, his eyes twinkling. "I don't think about what a bubble means. These words have become popular. I don't think they have any meaning." Fama wasn't kidding. He became so tired of seeing the word "bubble" in The Economist that he didn't renew his subscription.

"People have become entirely sloppy," he went on. "People have jumped on the bandwagon of blaming financial markets. I can tell a story very easily in which the financial markets were a casualty of the recession, not a cause of it."

The crux of Fama's argument was that the economic theories predicted the collapse of the mortgage market, in 2007. As job and income growth slowed, he said, some homeowners couldn't make their monthly payments, especially the subprime borrowers who had taken out the riskiest mortgages. With delinquencies and foreclosures rising, banks and other financial institutions that had invested heavily in subprime-mortgage bonds suffered big losses, which prompted them to cut back their lending to others. "As a consequence, we had a so-called credit crisis," Fama said. "It wasn't really a credit crisis: it was an economic crisis."

Fama's story was logically consistent, but it appeared to contain a big gap. If the mortgage blowup didn't cause the recession, what did? When I raised this question, Fama laughed. "That's where economics has always broken down," he said. "We don't know what causes recessions. Now, I'm not a macroeconomist, and I don't feel badly about that." He cackled again. "We've never done debates go on to this day about what caused the Great Depression.

A theory of the economic downturn that relies on inexplicable gyrations in the economy didn't sound like a great advance, but Fama seemed content with it. He insisted that the real culprit in the mortgage mess was the federal government, which instructed Fannie Mae and Freddie Mac to buy subprime mortgages and mortgage securities. "That was a government failure; that wasn't a failure of the market," Fama said. According to figures quoted in the Washington Post, Fannie and Freddie's purchases accounted for less than a third of the subprime market at the height of the boom. When I pointed out that private investors bought most of the subprime securities issued, and the two big government-backed mortgage companies considerably less, Fama said simply, "How much does it take?"

In addition to accusing the government of causing the subprime problem, Fama argues that it botched its handling of last fall's financial crisis. Rather than bailing out A.I.G., Citigroup, and other firms, Fama says, the Treasury Department and the Federal Reserve should have allowed them to go bankrupt. "Let them all fail," he said, with another laugh. "We've learned that lesson. We've learned that lesson with the two governments. These were big financial institutions. Some we didn't let fail. To me, it looks like there was not a lot of rhyme or reason to it." He conceded that the entire financial system might well have shut down for a period, but he expressed confidence that investors and healthy banks would have stepped in to buy the good assets of the collapsed firms, and that, within a week or two, the system would have been operating again. "It pretty much stopped for a week or two, anyway," he said. "The credit markets stopped for more than a week or two."

Fama was no less genial on the subject of Posner. "He's not an economist," he said. "He's an expert on law and economics. We are talking macroeconomics and finance. Even when I brought up Paul Krugman, who had criticized efficient-markets thinking in a recent essay in the Times Magazine, Fama's equanimity was unshaken. "My attitude is this," he said. "If you are getting attacked by Krugman, you must be doing something right."

In the office next to Fama's, I encountered another true believer, John Cochrane. During last year's financial turmoil, Cochrane, who happens to be Fama's son-in-law, helped to organize a petition against the Treasury Department's seven-hundred-billion-dollar Troubled Asset Relief Program; more than forty Chicago economists signed it. "What is there about recent events that would lead you to say markets are inefficient?" he said to me. The market crashed. To which I would say, We had the events last September in which the President gets on the television and says the financial markets are near collapse. On what planet do markets not crash after that?"

Earlier this year, Cochrane wrote several articles arguing that the Obama Administration's stimulus was based on a theoretical basis. When I brought up Posner and the broader Keynesian revival, he insisted that Keynesian economics had been plagued for decades with logical inconsistencies, which recent events had done nothing to remove. "We threw it out for a reason," he said. "It didn't work in the data. When inflation came in the nineteenth-seventies, that was a major failure of Keynesian economics."

After talking to Fama and Cochrane, I understood what Posner meant when he said, about two of his colleagues, "They bring in their guns." (Robert Lucas refused to see me, saying in an e-mail, "I don't want to do this." Elsewhere, however, I found more willingness to acknowledge errors and seek new ways forward. "There are a lot of things that people got wrong, and I got wrong, and Chicago got wrong," Gary Becker, who won the Nobel in 1992, said when I caught up with him late one afternoon. "You take derivatives and not fully understanding how the aggregate risk of derivatives operated. Systemic risk: I don't think we understood that, either—" at Chicago or anywhere else. Maybe some of the calls for deregulation of the financial sector went a little too far, and we should have required higher capital requirements. Although that was not just Chicago. Larry Summers—"the Harvard econo-
mist, who is now President Obama's top economic adviser—"when he was at Treasury supported deregulation.

Becker is famous for extending economic analysis to areas such as, for instance—causes output to fall and unemployment to rise, in the next period the economy automatically adjusts back to a state of full employment. The explanation for long stretches of mass unemployment, such as the Great Depression, is that workers refuse to accept lower-paying jobs and prefer to remain out of work. In such a world, most forms of government intervention are inherently futile. When I asked Becker about Lucas, he said that his colleague had made "a major contribution" to economic theory (he won the econom-
ics Nobel in 1995), but suggested that Lu-
cas's followers might have erred. "Some people did rule out the whole financial sec-
lor, seeing money as being unimportant," he said. "I think that stuff just turned out to be wrong." James Heckman, one of five current faculty members to win the econo-
ics Nobel, was more explicit in his criticism of Lucas's methods, and he told me that Friedman, who died in 2006, had also been skeptical of them. Dur-
ing the seventies, Heckman recalled, he and Friedman took part in the oral examina-
tion of a Ph.D. candidate whose thesis employed rate-of-expectations techniques, which were then sweeping the field. In the course of the examination, Friedman turned to Heckman and said, "Look, I think it's a good idea, but these guys have taken it way too far." By Chicago standards, Heckman is a centrist; his research on preschool educat
tion and other issues has influenced both Democrats and Republicans, and during the 2008 Presidential election, the Obama campaign asked him to assess its education proposals. Bush was skeptical of facts of league, he places a great deal of emphasis on incentives and has expressed skepticism about many government programs. "I think the underlying ideas of the Chicago School are very powerful," he said. "The base of the rocket is still intact. It is what we call the booster stage—the rational-expectations hypothesis and vulgar versions of the efficient-market hypothesis—that has run into trouble. I think what happened is that people got too far away from the data, and confronting theories with data. Part of that the Chicago tradition was neglected."

If the economic equivalent of a big bang is to emerge, it will almost certainly come from scholars much less invested in the old doctrines than Fama and Lucas. Ambitious tenure-track professors at Chicago, like their rivals at other schools, are busy trying to incorporate into their theorizing those factors that are not easily captured by traditional models. Their work has been their trascendence to reality, such as banking failures, financial-market bubbles, and credit crunches. This research presents a formidable challenge. A big reason that rational-expectations models were so appealing to economists was their tractability: with some clever math and a computer, they could be "solved" to generate explicit solutions for important economic variables, such as unemployment and inflation. Adding institutional detail complicates things greatly, so does allowing for psychological factors, such as overconfidence. "People say economics needs to incorporate the insights of psychology," Cochrane said. "Great. Thank you! I've heard that from Bob Shiller"—a well-known Yale economist, who wrote the 2000 book "Irrelevance Entropy"—"for 30 years. Do it. Let's see if you can explain the psychological state of the market."

That's hard to do.

In the nineteen-sixties and seventies, Chicago economics was largely cut off. Other leading schools, such as Harvard and Berkeley, rarely hired Chicago graduates, and Chicago returned the favor. Today, the gap is much narrower, partly because many of Chicago's ideas have become incorporated into mainstream thinking, and partly because it has recruited more widely. The most famous Chicago econo-

iest today is Steven Levitt, an M.I.T. Ph.D. and the co-author of "Freakonomics," who is known for innovative empirical studies of crime, abortion, and teacher performance. Richard Thaler, also a native of the city, is one of the few economists who has warned about the dangers of a financial crash. If a conference organized by the Fed in 2005, he said deregulation, trading in complex financial products, and the proliferation of bonuses for traders had greatly increased the risk of a breakdown. Senior Fed officials and other prominent economists dismissed his concerns. Lawrence Summers said that Rajan's critical tone supported "a ubiquitous view of misguided policy impulses."

Rajan, with his colleagues Douglas Diamond and Anat Shahar, has for years been examining potential problems in the banking sector. The work of this group didn't attract much public attention, but it turned out to be very useful to policymakers and other economists in analyzing the credit crisis and formulating the government's response, which Rajan supported. "Research drivers thinking, and there is all the finance that is based on it," he said. "People at the extremes get a lot of press—people who say, 'Let's do nothing, let's liquidate...'. There are people at Chicago who hold that view. There are some who say, 'Don't be too aggressive, don't do too much.' Rajan and Kashyap, meanwhile, advocated reforms in the compensation packages of Wall Street traders and C.E.O.s.

Today, though, the political and financial environment is somewhat different. Thanks to government action on an enormous scale, the housing system has been stabilized and the U.S. economy has expanded, if at a moderate pace. Ironically, the rescue program has taken some of the heat out of the economic debate. In Chicago, as elsewhere, most economists have returned to their own research projects. "If this recession had got a lot worse, we would have seen two major things," Rajan said. "Much more government involvement in the economy and a lot more concentration in economics on understanding what went wrong." Assuming that the economic recovery continues, there will be reactions like the revolution in the role of government and in thinking that dominated the economics profession after the Great Depression.

Becker may be right, but the impact of the financial crisis shouldn't be underestimated. Although he was a Chicago-style economist, Becker's work has been widely accepted worldwide, and he has been a beneficiary of Chicago's rival economics departments. Eventually, many of the founders of the Chicago School died, and were replaced by more moderate figures, such as Thaler and Lo. Now, it is a result of misguided efforts to extend deregulation legislation, and we have experienced the biggest housing bubble since the nineteen-thirties. Posner, who applied to be enjoying his new role as a hero, paused, then said, "So probably the term 'Chicago School' should be retired."

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John Cassidy talks about the Chicago School.