THESE ROGUES OF THE DISMAL SCIENCE HAVE BEEN VINDICATED BY THE ECONOMIC CRASH. HOW MUCH LONGER CAN MAINSTREAM ECONOMISTS IGNORE THE HETERODOX?

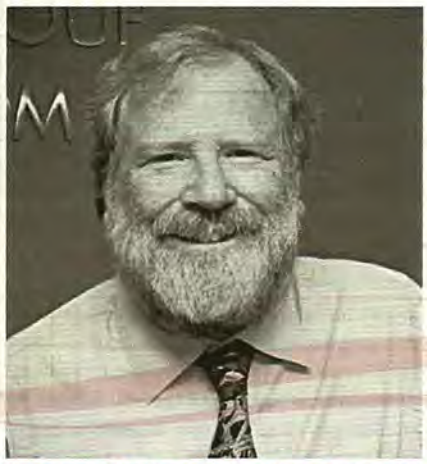
It was the kind of conference hall that makes you sleepy, with sound-absorbing walls and rows of plush chairs. William Black, a short, bearded man, wriggled the microphone free from the lectern. He wanted to wake up his audience. "Let me tell you all a story," he said, "about my former nemesis." Professors of economics don't usually have nemeses. But Black, now an associate professor of economics at the University of Missouri–Kansas City, hadn't always been a professor. In his former life as a leading bank regulator, he did battle with one of the most destructive white-collar gangsters in American history.

"Charles Keating," Black began, "loved to cheat little old ladies." Black described how one of Keating's frauds was to sell worthless junk bonds to elderly women who visited the "family-friendly" branches of Lincoln Savings and Loan. During Keating's trial, a victim told the jury she'd bought the bonds in order to purchase a special van for her handicapped daughter. These crimes had been documented adequately only after a criminal investigation of Lincoln Savings. Black explained that these kinds of stories helped convict Keating because they painted a vivid picture for the jurors. But such stories are uncovered only through criminal investigations. Inquiries? Stress tests? Accounting investigations? They ignore these stories. Without criminal investigations, the criminals always go free.

"THE OUTLAWS ARE ABOUT TWO PERCENT OF ACADEME AND ABOUT ZERO PERCENT OF FINANCE," SAYS ONE DISMISSIVE UNIVERSITY OF CHICAGO FINANCE PROFESSOR.

It was here that Black smiled and asked the audience a question: How many criminal investigations of major bank executives had taken place as a result of the crash of Lehman Brothers, the biggest financial crisis in the history of the world? The answer: not a single one.

In the religion of economics, Black is a heretic. He has no faith in the holy spirit of the market. He puts no emphasis on the true word of the math. His grand heresy was to demonstrate that financial markets are not efficient (i.e., self-corrective). Mainstream economists saw his recommendations for stricter regulation as "unrigorous" because he used the tools of a criminologist: historical precedent, common sense and an understanding of human failings.



PROFESSOR WILLIAM BLACK: HERETIC IN THE RELIGION OF ECONOMICS.

Black is not alone. He is a leading voice among a small group of economists who believe modern economic science simply doesn't understand the real world. Members of this loosely organized group call themselves, a bit dramatically, the heterodox. Many of them had predicted the financial crisis before it occurred and are now calling for real reforms in order to avoid an even bigger one. Like Black, they are ignored or belittled by most in their profession. Yet reality has issued a wake-up call. The financial crisis and ongoing recession have largely validated many of the heterodox positions on fraud, deregulation and debt. Could the mainstream still refuse to publish, cite or listen to them? I went to Denver last year to find out if the rogues of the dismal science were finally going to have their day.

•

It was the first night of the American Economic Association's annual convention, the biggest economics conference in the world. An hour before Black spoke, thousands of economists from all over the world were arriving at the Sheraton to collect their badges and schedules. I walked through the throng of the thin and the smart, taking in the economist vibe. The lobby vibrated with expensive eyewear and sensible laughter, healthy Ivy Leaguers greeting one another in complete, well-constructed sentences.

I have to admit I had come to the conference with a bit of an attitude. I grew up in the 1980s and 1990s, when economists were depicted as the high priests of money. Alan Greenspan, Ben Bernanke, Robert Rubin: These men were above politics; they were scientists. Who could argue against their proof? It was permanent boom time, the "end of instability." And then everything unraveled. The high priests turned out to have been Tartuffes. Their science was more Venkman than Egon. After the Lehman crash, the queen of England said it best when she asked one of London's economists point-blank: "Why did no one see it coming?" His stammering response was that of an entire profession called to task. I had expected some of that penitence to be on display at the conference. The atmosphere in the lobby that night seemed to imply

otherwise. Why was everyone in such a goddamn good mood?

I walked to the nearby Hyatt to attend the conference's opening panel, presented by the Association for Social Economics. I had assumed that being on the first panel of the conference was a big deal, a triumphant "keynote" moment for Black. But I was wrong. The conference hall was half empty, the crowd different. I took a seat in front of a man with a goatee longer than his face. My old olfactory enemy from college, patchouli, wafted through the air. As Black walked to the podium, I realized the well-dressed smarties back in the lobby weren't coming.

•

"I mean, every now and then there's an excluded subgroup that turns out to be right," said John Cochrane of the University of Chicago. Cochrane speaks proudly for mainstream, also known as neoclassical, economics. Talking with me over the phone before the conference, he made clear that his condemnation was general: "I haven't read their specific work. I'm busy, and I try to read what is considered interesting and valid." His position on heterodox economists was unambiguous: They're kooks. "They are about two percent of academe and about zero percent of finance." He was dismissive of their prediction of the credit-bubble collapse. "Beware those who predict nine of the last two crashes, okay? They're just not rigorous and don't use modern mathematical tools. This business is a wide-open meritocracy. You have to distinguish between closed minds and a lack of quality. The perception is that this is 1969 stuff. Give me new data and new ideas."

Cochrane's use of the word *rigorous* was something I'd heard from other mainstream economists when they dismissed the heterodox. Mainstream economists use complex mathematical models to test their hypotheses, building elaborate scenarios with hundreds of variables interacting with one another to simulate real-world events. If a theory is not "proved" in such a simulation, it's not valid.

As Yves Smith describes in her hilarious book, *ECONned,* economists fell in love with such models in the 1970s. Instead of analyzing history as social scientists, economists became soothsayers who could predict outcomes using models. Want to know the effect of a new rule on creditors of a bankrupt airline? Build a model of a bankruptcy and see how the rule affects it. Curious what impact a local Head Start program could have on property values? Build a model of an Alabama county and see.

The heterodox reject mathematical modeling as the ultimate proof, pointing out that the assumptions of any simulation dictate the results. Instead, many use mathematical tools to analyze existing data, a practice much older (and mathematically simpler) than modeling. A famous heterodox theory based on such analysis is Hyman Minsky's financial instability hypothesis, which observed in the 1970s that financial markets are inherently unstable because of the staggering amount of debt during bubbles. If today's regulators had used Minsky's model to guide policy during the credit bubble, they would have anticipated the financial fraud that brought about the collapse. Instead, regulators and academics in the early 2000s were busy making models that made risk disappear.

•

After Black finished speaking, the crowd drifted back to the reception buffet. As we gathered around the cheese and cold cuts, I learned that economists have a group and an opposing group for just about every opinion. The ASE is a heterodox group that believes economics should be used to promote social equality. Most panels at the conference were organized and attended only by people in their own groups. Instead of four days of debate and discussion, conferences have become institutional echo chambers. The only time you might meet somebody with whom you disagree is on the airport shuttle.

I was on my second drink ticket when I met Kellin Stanfield, a college professor who provided a different reason people might not want to attend heterodox panels: him. Under 40, his long goatee not yet gray, he had the well-fed look of a coffee shop manager who would get high with you before work. He explained he was presenting a paper advocating slavery reparations for African Americans. I asked if he was using any mathematics in his paper. He scoffed. The guy standing next to him nodded with approval.

BEN BERNANKE AND ALAN GREENSPAN: THEIR ORTHODOXY DIDN'T WORK.

As I wandered from group to group, I heard discussions about community farming co-ops in Philadelphia, the merits of the German model of union participation and a rambling diatribe about "the collapse of the capitalist model." From across the room, Black motioned that he was leaving. I quickly followed him out, a little disillusioned. His writings on financial fraud and deregulation were what had brought the heterodox to my attention. He offered real-world, commonsense solutions for industry and government in a time of ongoing crisis. Yet it seemed the only people listening to him were the ones who could do the least.

•

The next day I went back to the other side. At a panel simply titled "Financial Crisis," more than 400 people filled every chair in the room, with the front row taken up by reporters from the *Financial Times* and *The* *(continued on page 140)*

OUTLAW

(continued from page 106)

Wall Street Journal. Apparently I wasn't the only person hoping these men had a plan to fix everything. But I didn't see anyone from last night's panel. The goatee-to-tie ratio was a nonstatistical element.

The panel featured prominent economists from prestigious institutions. Instead of disagreeing with one another, they all seemed to be competing to make the same point in slightly different ways: The major banks had become dangerously big after the financial crisis. Five years ago most of these guys had been cheerleaders for deregulation. Now they had ditched their pom-poms for warning bells.

"We have not conquered risk. We need more fear," pronounced Myron Scholes, a Nobel laureate. "We need light regulation across the board. But we are not demonizing finance," said Raghuram Rajan, a professor at the University of Chicago. "We need to regulate how bankruptcy unwinds derivatives, but derivatives are still a good thing," said an enthusiastic John Cochrane. One of the panelists—Simon Johnson of MIT—even used the word *financialization.* He asked a rhetorical question: Why should finance be earning 40 percent of our GDP? What are the social gains? When he said this, the other members nodded and said nothing. Apparently it was easier to view it as a rhetorical question.

After the session ended, most of the participants were hustled from the stage for interviews and the next panel. Johnson stayed behind, taking time to talk with audience members who approached him. I asked him if mainstream economics was becoming more like heterodox economics. He glanced down at my media badge and looked me in the eye a little defensively. He quoted John Maynard Keynes, a patron saint of economic science. "Keynes said, 'When the facts change, my opinion changes.' How about yours?" He shrugged, clearly wanting to end the conversation. "The facts changed." He walked away quickly after giving me his card.

•

Mainstream economists' fear and loathing of government regulation are based on two cornerstone assumptions: that people are always rational and that people always act in their own interests. Therefore, any marketplace is a self-correcting entity, made up of informed sellers and buyers whose competition and self-interest enforce fairness and create total efficiency. These assumptions also allow human beings to be easily modeled mathematically.

Heterodox economists think these assumptions and models are hooey. To them, humans are social creatures who often fail at self-promotion because of things like stupidity, culture and niceness. Markets are therefore fundamentally destabilizing, inefficiently lurching toward monopoly, bubble or crash, desperate for the mitigating force of government or other institutions. With their focus on poverty and acknowledgment of class, the heterodox are the intellectual grandchildren of Marx. Perhaps that's why the family tree includes so many goatees.

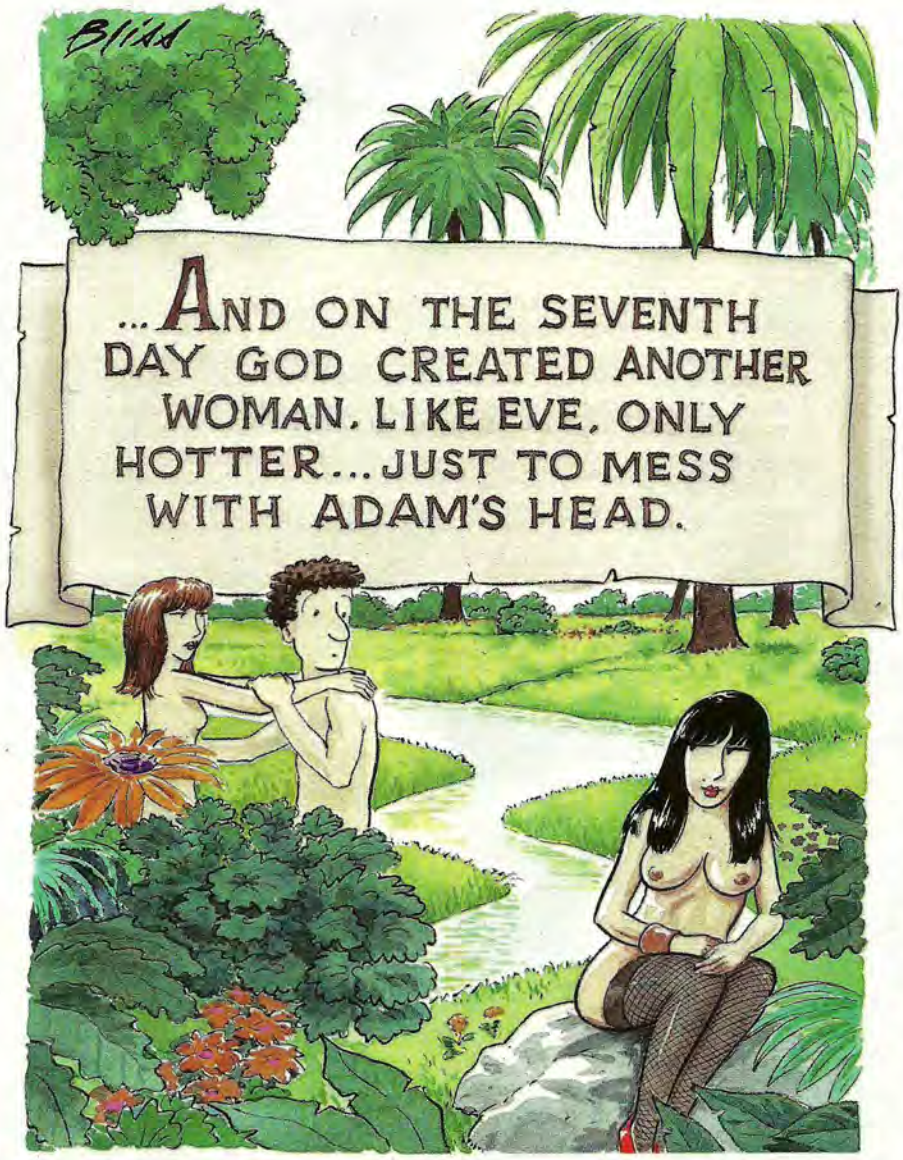
Even with the ghost of old Karl lingering, it seems obvious which worldview is more accurate: How many perfectly selfish, rational people do you know who don't work at an investment bank?

•

The next panel I attended was also about the financial crisis. But this one was organized by the ASE, with Black acting as a moderator. Instead of a packed conference hall filled with press passes, this panel resembled an AA meeting, with fewer than 15 people present. I arrived to find a long-haired Australian professor in his 50s wearing a tracksuit, presenting his paper. Instead of statistics, he was quoting Thorstein Veblen, who coined the term *conspicuous consumption.* The Australian's thesis? Since financial traders like to show off their money, they take more risks. Wow. No wonder *The Wall Street Journal* didn't make it over.

But it got better. I attended a presentation by the only African American person I heard speak at the conference, a straight-talking doctoral student named Aisha Meeks. She embraced a principle of heterodox economics—an interest in the poor. She had studied mortgage defaults in one of the poorest parts of Mississippi, establishing that the chance of default increased with the proximity to a payday lender. "Nobody has ever bothered to study these communities," she said. "Which means nobody can disagree with me." The next paper illustrated a second principle of heterodox thought—using existing data instead of creating theoretical data. The speaker had analyzed payroll data to show how the financial crisis increased the pay of specific racial groups within finance (turns out Hispanic women were big winners; black men, not so much).

Finally, as the moderator, Black spoke. "Why are we having more and more extreme crises? Why do we call it a subprime crisis when it was liars' loans that caused the problem? Institutions typically classified their liars' loans as prime. The industry's favored euphemism for a liars' loan—*alt-A*—would lead one to believe that such loans were prime. Why? They wanted to issue them so badly, 49 percent of 2006 loan originations called subprime were liars' loans. One third of total mortgage loans made in 2006 were liars' loans. Why would any institution do this? Because it



wasn't risk. It was fraud." He then advised those presenting their papers on this crisis to examine the role of fraud. For traders influenced by conspicuous consumption, was their behavior truly risk taking, with the fear of losing? Or were they gambling without fear, dishonestly inflating the short-term results to increase their bonuses? Were the racial groups not promoted during the crisis more culturally resistant to fraudulent activities and therefore less likely to succeed? For the payday lenders in Mississippi, how many are subsidiaries of major banks or tied to subprime lenders? Black was demonstrating the most relevant principle of the heterodox today—the belief that modern finance is a culture of institutional fraud that can be corrected only through criminal prosecution.

To say fraud is a blind spot within mainstream economics would be an understatement. Black had explained earlier: Fraud is not a rational action because getting caught is too large a price to pay for the gains. Even worse, a CEO who trashes his own financial institution, like Keating (or perhaps Jamie Dimon or Ken Lewis), actively distorts the metrics of his institution's success in order to receive personal bonuses. Mainstream economists don't study this kind of fraud because it is hard to model and shatters the illusion of market correction. In the 200-page schedule that listed every panel and event at the conference, the word *fraud* was mentioned only once—when Black was speaking. After the Lehman crash, which was driven by perverse incentives within banks, that doesn't seem like blindness. That seems like willful exclusion.

•

L. Randall Wray is a provocateur of the heterodox group. He is Black's younger, feistier colleague at the University of Missouri–Kansas City, appearing as the heterodox voice at panels and conferences around the world. Unlike Black, who became a professor after being a regulator, Wray chose his path as a heterodox economist while a graduate student. I asked him why. "Neoclassical economics doesn't make sense when you first learn about it," he said. "But it makes even less sense the more you study it and try to use its tools. I was lucky to have been taught by a man who was one of the original dissenters." Wray's mentor was Minsky, who had made it his life's work to disprove the efficient-market hypothesis. Minsky was ignored for 20 years, working without tenure when he first taught Wray. "When I met him," Wray recalled, "he was pretty depressed. He shuffled into our classroom, all hunched over, wild gray hair. The first thing he said was, 'What I want is the last person who comes into the classroom to always close the door. I don't want anyone to know what goes on in here.'" Describing his mentor's path, Wray said, "He had been predicting instability and crisis starting in the 1950s, and nobody listened. The entire science of economics had become an argument to leave markets alone, that regulation was only getting in the way. By the mid-1960s he could no longer publish in the top journals. There was a period of 20 years when he considered himself a total failure. Then in the 1980s he suddenly became popular again because of the S&L crisis. People were desperate to understand what had happened, so they dug up his old papers and started citing him again. This happened when I was his student. It was great to see him finally vindicated, if only briefly."

I asked him what being a heterodox economist meant today. Wray shook his head. "It still means you will never be published. You'll probably never teach graduate students. I was lucky because I got into UM–KC, which is one of the only programs in the country that supports heterodox thought." I asked if he ever hoped to have an influence on government regulation or monetary policy. "The neoclassical guys already have their answer to the crash—too much government regulation."

If it was such a hopeless cause, why fight the battle? Isn't there a middle ground?

Wray grinned. "The first conference I ever attended, I saw on the schedule there was a panel on suicide. I went to see what it could be about. Here was their thesis: Suicide must be a rational behavior. The conclusion was that suicidal people have a high rate of something called a 'time discount,' which means they are able to delay gratification for a future reward. They enjoy flying through the air so much that the three seconds of flight offsets the rewards that come during the years remaining in their lives." Wray laughed. He had the mad look of a lifelong dissenter. "They presented this with a straight face, with mathematical models that proved their thesis. And people applauded." He stopped laughing. "So follow the same logic into finance: Borrowers never lie. Markets set the perfect interest rate. This mass delusion allows for mass fraud. Because the so-called true believers are also careful to flee the markets they claim are so efficient before these markets crash. Their superiority and sophistication are part of the efficiency. Everyone in finance and academe knows the macro model of today is really just pump and dump on a grand scale. The orthodox approach says you can always sell. But only the sophisticated players know when. Everyone else—low-wage workers, government, pensions, our families—are the ones who pay." There was no middle ground. To Wray, it didn't matter that in 20 years it could be him shuffling into that classroom. *(concluded on page 145)*

OUTLAW

(continued from page 142)

He would continue to fight to stop economics from being the science of the bubble.

•

That night I wandered around the receptions and social events in the hotels. Most economists look like perfect dinner guests and speak with eloquence. I thought it would be easy to get these talkative people to talk to me. But I made a mistake. I kept using the word *heterodox*.

I spoke with three good-looking young guys as we walked between hotels. They were in their early 30s, friends from their grad program, walking briskly in their standard-issue long black overcoats. The blond one was the leader. Harvard had given him an air of aggressive, instant appraisal, and he didn't want to talk to me. When I asked if they were heterodox economists, they all laughed. "Those guys are kind of weird. We don't have any teaching in our department," said the friendly Asian one. Did they ever read anything by heterodox economists? Before he could answer, the blond decided to walk faster and ignore me. The three of them walked on, the Asian waving apologetically. This pattern of conversation was repeated with different groups throughout the hotels: the young Russian American guys who worked in government and thought heterodox economists were "complaining about the way things naturally are." The two Canadian women who weren't sure if heterodox economists were "relevant." The drunk 60-year-old in a tuxedo who laughed and called heterodox economists "journalists, not economists." I was ready for people to start spitting on the ground and making the sign against the *malocchio*. It was that bad.

Later that night I found myself with a man who was what I had assumed every economist was: a curious intellectual who used statistics and an understanding of commerce to solve problems. We sat at the hotel bar for a final drink. "What is a heterodox and what is an orthodox?" he asked. "These terms do not really mean much. I've done papers statistically proving racial bias, which is a quite heterodox inquiry, but I used conventional neoclassical methods and mathematical formulas to prove it. Does that make me a heterodox guy? Who cares, right?" I brought up how heterodox economists define themselves by renouncing rationality and market efficiency. He laughed, waving my comment away. "That is stuff you discuss at three in the morning back at your dorm. It's too big or philosophical; it is not part of day-to-day inquiries. How efficient are markets? I don't know. But my inquiries are still valid. Neoclassical mathematics has given me too many great tools to say otherwise." His agnostic approach was one of the most hopeful things I heard at the conference. It also underlined one of the heterodox's biggest, self-imposed weaknesses. By refusing to acknowledge mathematical modeling as valid, many heterodox economists were missing tools that could help quantify their own theories. More vigorous mathematics would also perhaps raise the bar and keep some of the undesirables out of the party.

•

Black had explained how mainstream economists' blindness to fraud had helped create the recession. James Galbraith told me something positive: Such a blind spot wouldn't last much longer. But not for the reasons you might hope.

Galbraith, one of the leading heterodox economists of his generation, is a big, serious-looking man. His recent book, *The Predator State*, describes how wealthy individuals and corporations have taken control of government institutions in order to enrich themselves. Sitting in the fading light, the hotel room growing darker around him, he tried to summarize more than 30 years of work in opposition to the mainstream.

"The history of neoclassical economics is one of a long retreat from indefensible positions. Different economists—call them heterodox if you like, though I don't personally like that term—have sat at the fringe, disagreeing with the entire neoclassical premise of equilibrium and rationality. Every 10 years or so, the mainstream will acknowledge their mistake on a certain issue of the day and work to contain the damage so that their acknowledgment doesn't contradict their fundamentals. This isn't good. It would be better if they admitted they keep making mistakes because their underlying assumptions are wrong—but it does mean that they can adjust." Galbraith then listed some examples of the mainstream co-opting heterodox opinion. "In the 1980s, they mostly abandoned the belief in rational expectations, changing their mathematical models. In the 1990s, it was the disproven belief of a natural level of unemployment. In the 2000s, the law and economics movement argued that laws and enforcement were not as efficient as markets in punishing wrongdoing, a concept now totally disproven."

I asked him what was next. Could it be fraud? "The next big mea culpa could be their acknowledgment of the much bigger role of fraud in finance. But so many things this crisis has highlighted contradict their point of view, it is hard to predict which ones they will be forced to acknowledge."

I thought of the panel I had attended earlier in the conference, where the neoclassical stars were so fearful of the megabanks their policies had helped create. Galbraith sighed in the dim light. "They never cite our writings in their papers or lectures. They discover something we've been saying for years because they've built a mathematical model that supports it. That's how they control the conversation and maintain their control on their academic and policy institutions. When we say it, we're 'not being rigorous' or we are 'politically biased' or whatever. Only when they say it does it become true."

•

One of the last panels I attended featured actual regulators from the Bank of England and the Korean government, sharp nonacademics who described their attempts to understand and regulate financial markets. The fear of the big banks was here too but in much starker terms: One speaker presented different methods of how the Korean government might insure an institution that had accrued debt the size of his country's GDP.

I couldn't help feeling that it all seemed too little, too late. From their positions as leaders of the IMF, the U.S. Treasury and the Federal Reserve, a generation of mainstream economists had created the most fragile, crash-prone system of finance the world has ever known. No one onstage mentioned the words *fraud* or *prosecution* or *criminal investigation*. If huge players control everything through the threat of their own collapse, isn't it time for more radical ideas?

The day before, I had asked Black if he ever wanted to be a regulator again. His quiet answer didn't surprise me. "Yeah. There are a bunch of folks just like me. We're all in our prime now." He laughed, eyes glinting. "We were kids before, making it up as we went, pretty successfully, but still. Now we have the benefit of hindsight. We've studied all this stuff and have the benefit of all these life experiences, and yet still nothing. Why wouldn't they want to talk to someone who had experience successfully responding to a crisis involving massive fraud, deregulation and desupervision?" The answer seems obvious. Black is famous to historians of the S&L crisis. But he is famous for the wrong reasons. The people he would put in jail today are the ones controlling the regulators, not fearing them.

I had come to the conference hoping to see a thriving resistance movement. The world was in crisis. There would be urgency and questioning and new directions found. I had imagined the heterodox economists engaging and challenging their colleagues, with policy wonks being asked hard questions and professors renouncing their past positions. Instead, I had seen a conference almost entirely free of dialogue, with the two sides segmented in their own separate receptions, panels and dinners. The big stars from Yale and Chicago calmly puzzled over the chaos and loss their mathematical models had helped create. Down the hall the heterodox economists shook their fists and pulled on their goatees. How long until the ones with the math and the influence started listening to the ones with the history and the real-world ideas?

Walking through the busy lobby of the Sheraton, I noticed the crowd of departing economists was so large it had spilled out onto the sidewalks of downtown Denver. The clusters of long black overcoats, laughing and talking, would part automatically for the everyday residents of Denver to pass through. A young Hispanic family walked by, the burly father in a Broncos jacket, his kids holding his hands. His wife glanced around, uncomfortable: Who were all these rich white people? A little behind them, a man in his 50s who might have been homeless walked through. Had the industry that had once employed him been reorganized because of one of the men in the crowd? Had his unemployment benefits been cut because of someone else's mathematical model? He paused amid the hubbub and peered into the crowded lobby the way homeless men will do. The laughing and the talking continued in the cold Denver air. To the economists around him, he was invisible.