Cognitive dissonance, the Global Financial Crisis and the discipline of economics*

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Abstract

The global financial and economic crisis has produced a powerful shock to the worldview of an influential group of economists whom I call *believers in laissez faire* (BLF). I provide evidence which suggests that the BLF responded to this shock in a manner that can best be described as irrational, ill-considered and clearly erroneous. I consider the social-psychological concept *cognitive dissonance* as the best explanatory framework for understanding this response. Cognitive dissonance theory predicts that when real-world events "disconfirm" deeply-held beliefs this creates psychological discomfort in persons and they will respond by means of distortion and denial. I test the proposition that the BLF experienced cognitive dissonance through a survey in which I asked two groups of economists what their views were on 10 possible causes of the Great Recession. One group consisted of the signers of the notorious open letter circulated by the Cato Institute opposing President Obama's stimulus program. (I consider members of this group to be self-proclaimed BLFs.) The second group consisted of a random sample of members of the American Economics Association. One of the possible causes I listed on the survey is the U.S. Community Reinvestment Act (CRA) of 1977. The notion that the CRA is a major cause of the crisis apparently has great resonance among the BLF but is demonstrably false. Among other results, 46% of the signers of the letter believe that the CRA was one of three top causes of the crisis compared to 12% of the "other" economists. I conclude that the BLF exhibit symptoms to cognitive dissonance.

The global economic and financial crisis of 2007-2009 (?) provides a rare natural experiment for the study of the social psychology of the economics profession. The "sub-prime" crisis of 2007, the banking crisis and credit crunch of 2007-2008 and the deep global recession which started in the United States in December 2007 constitute a powerful shock to the worldview of an influential minority of economists consisting of new classical economists, real business cycle (RBC) theorists, some new Keynesians, so-called "Austrians," the monetarist remnant, many (most?) financial economists and assorted other *believers in laissez-faire*.[1] I call them the *BLF* for short. In the words of the title of a recent working paper, they have been "Slapped in the Face by the Invisible Hand."[2] (Gorton, 2009). It is important from society's (and the profession's) point of view to try to understand the BLF's responses to the crisis (and to predict future responses) since they have wide influence on (and often dominate) public policy discussions, especially those involving macro policy and financial regulation. They seem to be in a position to shape the "conventional wisdom" disseminated by elements of the media, institutions such as the O.E.C.D. and G-20, a number of developed-country governments and some circles within the central banking universe.[3]

My aim in this paper is to apply the concept *cognitive dissonance* (CD) to illuminate the BLF's responses to the crisis. At least since the work of Akerlof and Dickens (1982) CD has been employed by economists to study both conventional and unconventional economic

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[1] For the start of the recession see http://www.nber.org/cycles.html

[2] For a recently published book with an almost identical title see Gorton (2010).

[3] This can be seen in the "deficit hysteria" described in Nersisyan and Wray (2010). On the O.E.C.D. and deficits see for example Spicer and Younglay (2010). See also Trichet (2010).

topics.[4] Akerlof and Dickens themselves apply it to a labor market "anomaly," namely the pervasive breaking of workplace safety standards by workers in risky occupations. Of course Akerlof and Dickens and subsequent writers employ CD to examine the behavior of the usual "agents" who are the subjects of study by economists: consumers, workers, entrepreneurs, investors (and more recently, voters, bureaucrats and politicians), whereas I intend to apply it to *economists*. But I justify this by an appeal to authority: In his presidential address to the Western Economics Association, Milton Friedman (1986) said about economists, "[w]e cannot in good conscience interpret ourselves as behaving differently from those we analyze. We cannot treat ourselves as an exception."[5] (p.8)

I proceed as follows: In the first section I state briefly why I view the BLF as adherents of an *ideology* rather than upholders of a "paradigm" or participants in a "research program," [i.e., the well-known concepts introduced respectively in Kuhn (1962) and Lakatos (1970)]. In the second section I argue that CD offers a useful approach to explaining why adherents of ideologies (including economic ideologies) cling to them with such tenacity and resist efforts to challenge them. I call this the "CD hypothesis." This adherence to an ideology (or "model", as the collection of ideas, attitudes and beliefs which constitute an ideology may loosely be called) has been well-described by Solow (2005): "It can become very difficult ever to displace an entrenched model by a better one. Clever and motivated–including ideologically motivated–people can fight a rearguard battle that would make Robert E. Lee look like an amateur….Old models never die; they just fade away." (p. 94). In the third section I show that a series of clearly irrational responses to the crisis in public statements by prominent BLFs provide evidence in favor of the CD hypothesis. In the fourth section I discuss frequent assertions by some economists as well as non-economists in the past three years that the U.S. financial crisis can in large part (if not entirely) be blamed on the U.S. Community Reinvestment Act (CRA) of 1977 which attempted to reduce discriminatory lending practices by banks in communities where they obtained their deposits.[6] In the fifth section I show that there is overwhelming evidence that the "CRA hypothesis" is false and that adherence to it can be viewed as an indicator of the presence of cognitive dissonance among the BLF. In the sixth section, I report on a web-based survey in which I attempted to ascertain the views of two groups of economists on the causes of the Great Recession of 2007-09: Group A consisted of the signers of the notorious Cato Institute open letter which epitomizes the views of economists opposed to the ARRA, President Obama's fiscal stimulus program.[7] (I consider this group to be self-proclaimed BLFs.) Group B consisted of a random sample of members of the American Economics Association (AEA). I found that there are significant differences in the views of the two groups. Members of group A are much more likely to blame the CRA for the crisis (as well as the so-called "government-sponsored enterprises" or GSEs) than are members of group B. This result suggests that cognitive dissonance can be attributed to the BLF. In the seventh section I conclude.

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[4] See the many references with the words "cognitive dissonance" in their title.

[5] Throughout this address Friedman naturally emphasizes the role of self-interest in explaining the behavior of business people, politicians and bureaucrats as well as economists but surprisingly he interprets the term extremely broadly. He asserts that "…self-interest is not restricted to narrow material interest. It includes the desire to serve the public interest, to help other people." (p.9)

[6] Public Law 95-128.

[7] American Recovery and Reinvestment Act of 2009 (Public Law 111-5)

1.

What is the nature of the response to the most severe financial and economic crisis since the Great Depression one might expect (or hope for) from a group of professionals who aspire to the title "scientist?"[8] Ideally the response would be the one exemplified by a statement attributed to Keynes: "When the facts change, I change my mind. What do you do, sir?" (Malabre 1994, p. 220) Such an idealized (if over-simplified) view of the process of scientific inquiry is sometimes presented in science (including social science) textbooks in the form of a flow chart, which Blachowitz (2009) following Rudolph (2005) calls the step-by-step algorithm ("observe", "hypothesize"," test").[9] But it has been widely understood at least since the work of Kuhn (1962) that the development of science is not as straightforward as this picture indicates. Instead, practitioners of particular scientific disciplines or "scientific communities" cling to "constellations of beliefs, values, techniques, and so on" (i.e., Kuhn's *paradigms*) which members of those scientific communities are reluctant to relinquish. [Kuhn (1996, Postscript 1969)] It seems clear that the BLF do not constitute a "scientific community" in the sense of Kuhn: They may share many (important) "beliefs, values…and so on," but not techniques (or methodologies). More generally they do not necessarily share a common set of attitudes about the nature of social-economic processes and social-scientific inquiry. Thus, for example, one wing of the BLF insist that the only proper approach to macroeconomics consists of constructing DSGE models based on utility-maximizing representative agents ("micro-based macroeconomics"). [See Kocherlakota (2010) and Chari (2010)] A recent outburst along these lines appears in Athreya (2010, p. 3), who, in the course of arguing that no one who has not had at least "a year of PhD coursework in a decent economics department (and passed their PhD qualifying exams)" should publicly comment on macroeconomic issues, asserts that "[m]acroeconomics is most narrowly concerned with the tracing of individual actions into aggregate outcomes," i.e., with the construction of representative-agent-based models (p. 3). This methodological perspective is vehemently rejected by Austrians. [See, e.g., Garrison (2009)] Similarly, adherents of new classical economics ("equilibrium macroeconomics") and RBC theory reject the possibility of monetary policy effectiveness while new Keynesians do not. [See Lucas (1996) compared to Taylor's (1993) eponymous rule][10]

So I maintain that different groups among the BLF might go at each other hammer and tongs in seminar rooms, the pages of scholarly journals and on weblogs, but how would they interact "on the barricades?" Even the most superficial acquaintance with their writings makes it clear that in defense of "the market" the BLF are close allies, no matter what their positions on theory and methodology. Thus in the midst of a vigorous attack on Prescott on the *Mises Economics Blog*, Kraus (2009) finds it possible to say that "[i]f one just skims through the slides [of a Prescott presentation], one might notice some good points about 100 percent bank reserves, lower tax rates, the evil of stimulus packages etc." [See Prescott (2009)] It is thus a shared outlook, i.e., a common set of attitudes and beliefs (without necessarily shared methodologies or theoretical perspectives) which strongly suggests that the BLF are the joint upholders of an *ideology*. According to Eagleton (1991, p. 2), "[n]obody

[8] After all, the stars of our profession receive the Swedish Royal Bank's Prize in Economic *Sciences* in Memory of Alfred Nobel. See the website Nobelprize.org.

[9] See also NASA.

[10] But for recent claims of "convergence" among macroeconomists see Woodford (2009)

has yet come up with a single adequate definition of ideology…" He then proceeds to list 16 definitions ranging from what Freeden (2003, p. 1) called the "ill-reputed," ("false ideas which help to legitimate a dominant political power") to the more or less neutral ("action-oriented sets of beliefs"). For my purpose in this paper a relatively neutral definition is appropriate, hence I define ideology as a more or less coherent and stable set of ideas, beliefs, and attitudes concerning some particular part of the social-economic-political world. The "set of ideas, beliefs and attitudes" of the BLF are of course well-known: they strongly believe in the virtues of markets because of their efficiency properties but also for moral-ethical reasons; they believe in the self-adjusting or self-correcting economy and therefore abhor government interventions of all sorts. Along with this core set of beliefs there goes a penumbra of vaguer attitudes with respect to private property rights, the legal system, the overarching value of (particularly) economic freedom, etc. It is this *ideology* which the BLF defend with great vehemence.

2.

Why would a group of trained professionals, practitioners of a scientific or scholarly discipline (or any educated person for that matter) adhere to an ideology and refuse to abandon it in the face of evidence undermining its tenets? In the language of social psychology such a state of affairs involves an inconsistency in "cognitions," (i.e., "…any knowledge, opinion, or belief about the environment, about oneself, or about one's behavior.").[11] Festinger (1957, p. 3) called such inconsistencies *cognitive dissonance* and hypothesized that they cause psychological discomfort in individuals which they strive to reduce or eliminate. He added that "[w]hen dissonance is present, in addition to trying to reduce it the person will actively avoid situations and information which would likely increase the dissonance." (p. 3) Cognitive dissonance theory has had its ups and downs over the past half century [see Aronson (1992)] but it has become the default tool for economists studying a variety of phenomena involving apparently irrational, inconsistent or self-defeating behavior or at least behavior that does not conform to the predictions of rational choice models. [See for example Goetzmann and Peles (1997), Goldsmith et al. (2004), Hosseini (1997), Konow (2000), etc.] Akerlof and Dickens have translated these propositions into language amenable to economic "modeling" as follows: "First, persons not only have preferences over states of the world, but also over their beliefs about the state of the world. Second, persons have some control over their beliefs; not only are people able to exercise some choice about beliefs given available information, they can also manipulate their own beliefs by selecting sources of information likely to confirm 'desired' beliefs." (p. 307) Finally for Batson (1975, p. 176) "[c]ognitive dissonance theory assumes that man is a rationalizing animal, actively defending himself by means of distortion and denial against information which contradicts deeply held beliefs." An obvious question is, which of his or her ideas, beliefs, or attitudes will a person most energetically defend? The broad answer clearly is that it is a function of their "importance," to the individual, to use the word chosen by Festinger or those that are "most deeply held" in the words of Batson. (See Festinger, p. 16) Which ideas, beliefs, and attitudes are "most important" or "most deeply held?" A widely, though not universally accepted answer to this question is, those that are most closely tied to a person's "self-concept," i.e., a person's view of herself or himself as competent, intelligent, moral, and so on. [Aronson (1999)] An additional useful proposition in cognitive dissonance theory is the following: Aronson and Mills (1959) found, perhaps counter-intuitively, that "…people who go through a severe initiation in

[11] See Festinger (1957, p.3)

order to gain admission to a group, come to like that group better than people who go through a mild initiation to get into the same group." The relevance of these considerations to an examination of the social psychology of the economics profession was succinctly expressed in a remark by Krugman (2009a) on his blog at the *New York Times*. In response to attacks on him following his devastating assault on the "modern macro" wing of the BLF he writes about them as follows: "They're smart! They work hard, using hard math! How dare I say such a thing!"[12] I conclude, in other words, that the ideology embraced by the BLF has become a component of their self-concept, in part at least due to the hard work required to enter the group. They will react to any threat to their core beliefs represented by events in "the real world" by means of "distortion and denial." Given the above, I consider irrational, ill-considered, clearly erroneous responses by the BLF to the current crisis as symptoms of cognitive dissonance.

3.

In this section I present several examples of statements made by prominent BLFs dealing with the crisis of 2007-2009. In some of these examples I leave it up to the reader to decide whether they fit the description of "irrational, ill-considered or clearly erroneous responses."

- According to John Cochrane, a prominent University of Chicago economist, "[we] *should* have a recession. People who spend their lives pounding nails in Nevada need something else to do."[13] (Lippert, 2008) This remark is reminiscent of a statement by Andrew Mellon, Herbert Hoover's Secretary of the Treasury in the early stages of the Great Depression, as quoted by Hoover in his memoirs (Hoover, 1951-1952): "'Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate'. He held that even panic was not altogether a bad thing. He said: 'It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people.'" In other words, the notion that recessions and depressions serve a useful economic function is clearly not new; see for example the views of Schumpeter (1934, p. 16) as cited in Caballero and Hammour (2005). But it might be considered by many as an unusual viewpoint, to say the least, in the first decade of the 21st century.

- Casey Mulligan, a second prominent member of the Chicago school wrote a blog entry on the *New York Times* web site entitled "Are Employers Unwilling to Hire, or Are Some Workers Unwilling to Work?" (Mulligan, 2008) The title of the piece is self-explanatory. (Mulligan concludes that a decline in labor *supply*, not labor demand was the source of rising unemployment at least in the early stages of the 2007-2009 recession.) This view does not require elaborate analysis. A brief look at a relatively new data set can clarify the issue. The figure below shows the ratio of unemployed workers in the United States to the number of job vacancies obtained from the Bureau of Labor Statistics' JOLTS survey.[14] It shows that since the start of the 2007-

[12] See Krugman (2009b) for his views on "modern macro."

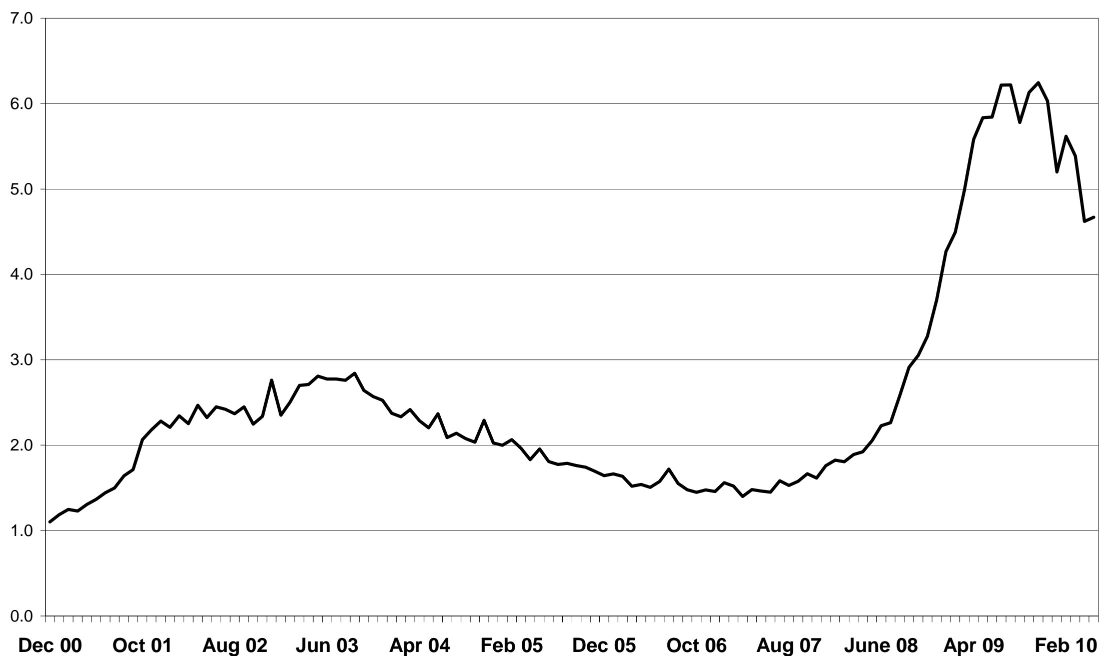
[13] Emphasis added.

[14] The ratio was calculated by the author. Data on job openings are available at http://www.bls.gov/jlt/home.htm

2009 recession this ratio has almost quadrupled. This should have put to rest Mulligan's argument that the rise in unemployment in the United States can be attributed to a drop in labor supply as opposed to a drop in demand (but he has repeated it on several subsequent occasions).[15]

- Robert Barro, economics professor at Harvard, questions the legitimacy of standard calculations of fiscal multipliers and thus the efficacy of countercyclical fiscal policy. He uses as a counterexample the case of World War II. Since U.S. defense spending rose by $540 billion per year (in 1996 dollars) at the peak in 1943-1944 and real GDP rose by only $430 billion per year he concludes that the multiplier was 0.8! He ignores the fact that the multiplier concept does *not* apply in situations of (i) full employment (and during World War II the domestic U.S. economy "enjoyed" over-full employment) and (ii) through rationing and other devices spending on domestic consumption and investment was deliberately suppressed to free up resources for the war effort (Barro 2009a and 2009b). It is of course perfectly legitimate to question the effectiveness of fiscal policy as a countercyclical policy tool and to dispute the correctness of multiplier calculations; it is the use of an obviously mistaken counterexample such as the case of World War II that suggests an irrational or ill-considered response.

Ratio of Unemployed to Job Openings, 2000-2010



- Eugene Fama, also of the University of Chicago presents the national income accounting identity ("saving equals investment") in the following form:

$$PI = PS + CS + GS \qquad (1)$$

(PI = private investment; PS = private saving; CS = corporate saving; GS = government saving) (Fama 2009). Based on this identity Fama claims that fiscal stimulus is completely ineffective since an increase in the government's deficit (i.e., a

[15] See for example Mulligan (2010) and the response by Tim Duy (2010).

reduction in government saving, GS) will automatically reduce private investment since “the money has to come from somewhere.” That is, the government’s deficit has to be financed from private sector saving (PS + CS) which will then not be available for private investment. In other words, Fama assumes complete “crowding out” of private investment. (He presents an analogous argument for the use of the revenue side of the budget for stabilization purposes.) But for approximately 60 years undergraduates at least in the English-speaking world have been taught the difference between an *equality* and an *identity* in macroeconomics. During any time period equation (1) is of course true *by definition* (i.e., *measured* saving equals *measured* investment) but this says nothing about *planned* (*ex ante*) saving and *planned* (*ex ante*) investment; hence nothing can be concluded logically about the effects of a government budget deficit (lower GS) on private sector saving or private sector investment. As several people have pointed out, what seems to be involved is an old error of the 1920s and 1930s, i.e., the so-called “Treasury view.” (See for example DeLong, 2009)

There probably would be wide (although obviously not universal) agreement that these examples exhibit “irrational, ill-considered, and clearly erroneous responses” to the crisis by prominent BLFs and this suggests the presence of cognitive dissonance. But the case for CD as an explanation is obviously not definitive since other motives may be at work, such as the one invoked by Upton Sinclair (1994, p.109): "It is difficult to get a man to understand something, when his salary depends upon his not understanding it!" Although the four examples involve tenured academics, one might still claim that benefits accrue to them from publicly upholding “free-market” ideology (and they would incur costs from weakening their public support for that ideology).[16] To make the case for CD as an explanation more convincing two things are required: first, a clear example of a widely-held false belief about the causes of the crisis, second, an *anonymous* survey which would eliminate the problem created by public statements. In the next two sections I present the case for the CRA as a major cause of the crisis as a clear example of a false explanation and in the sixth section I report on survey results which strongly suggest the presence of CD among a group of self-proclaimed BLF.[17]

4.

The current public discourse on the origins of the global financial crisis both among economists and non-economists frequently revolves around the question, is it the fault of the “government” or the “market”? This can be seen in articles by prominent economists with titles such as “A Government Failure, Not a Market Failure,” [see Makin (2009)] and “How Government Created the Financial Crisis,” [see (Taylor (2009)] I find this question to be superficial and uninteresting. I take it for granted that the crisis is a “joint product” of the financial “industry” *and* national governments. [See Kessler (2010)] But I consider it symptomatic of the cognitive dissonance I believe to be prevalent among the BLF and I view

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[16] Of course, some outspoken BLFs who make “irrational, ill-considered or clearly erroneous statements” may be angling for a position in a future administration.

[17] In my view the claim that the “government-sponsored enterprises” (GSEs) are responsible for the crisis is equally fallacious. But the GSEs are in fact so heavily involved in housing finance in the United States that to demonstrate their “innocence” requires a much more elaborate analysis than I am able to present here. Hence my concentration on the CRA.

the acceptance and promotion of one variant of the claim that "the government did it" as an indicator of cognitive dissonance among this large group of economists. This is the notion that a cause (or *the* cause, depending on the writer) of the current crisis can be found in the Community Reinvestment Act (CRA) of 1977, as amended in the 1990s, a law which was designed to encourage depository institutions in the United States to supply credit to low- and moderate-income communities from which they accept deposits. The more immediate stated objective was to eliminate "redlining," the policy of discriminatory lending practices in low-income communities.[18]

An often-repeated narrative laying out the CRA–crisis link goes something like this: At the time of its passage the CRA's requirements were vague and difficult to enforce. With the arrival of the Clinton administration enforcement was strengthened and the law itself was amended in 1995 and "given teeth." As a result, banks were forced by regulators to weaken their lending standards and to extend mortgage credit to unqualified borrowers–hence the rapid expansion of the so-called "sub-prime" mortgage market between 2002 and 2006. Unsurprisingly, especially because of the slowdown in housing price increases and subsequent price declines in 2006 and 2007, sub-prime borrowers were unable to meet their obligations, hence the explosion of defaults and foreclosures in 2007 and 2008. It is widely accepted that the meltdown of the sub-prime market served as the "trigger" for a further meltdown of the real estate market as a whole which ultimately led to the current crisis. So there you have it: strengthening the CRA led to a weakening of lending standards which led to an expansion of sub-prime lending which in turn led to the collapse of the sub-prime mortgage market, and everything else follows.[19] It is difficult to trace the origin of this notion but I believe it started with a provocatively titled piece by Thomas DiLorenzo (2008). Other economists, both prominent and obscure who contributed to it to one degree or another are Horwitz (2008), Meltzer (2009), Boskin (2008), Rizzo (2009), White (2008) and several others.[20] in the next section I discuss why it became clear fairly quickly that this is a false narrative.

5.

As we have seen, some economists (and many noneconomists) attributed the 2007-2009 crisis at least in part to the CRA's role in encouraging (CRA-covered) institutions to lower their credit standards and to engage in risky lending practices. This in turn, it is claimed, ultimately led to the meltdown of the housing market in the United States and the related markets for mortgages and mortgage-backed securities in their various incarnations. This view has been rejected by Federal Reserve officials [see Kroszner (2008) and Yellen (2008)] and other informed individuals [see Bair (2010)] so that one can feel fairly confident in concluding that the "CRA hypothesis" is false.[21] But since I view this notion as part of the

[18] See Federal Financial Institutions Examination Council's (FFIEC), Community Reinvestment Act, available at http://www.ffiec.gov/cra/default.htm

[19] Wallison (2009) is typical of this style of narrative.

[20] Boskin does not actually mention the CRA but he uses the following phrase: "[t]he laudable efforts to expand home ownership to low-income people wound up being a prime contributor to the current economic crisis," which is more or less equivalent to blaming the CRA.

[21] Bair deserves to be quoted in full: "But as we go down the list of what went wrong, let me reiterate that this crisis was not caused by the Community Reinvestment Act. Bank regulators are unanimous on that point. To be sure, the CRA encourages banks to make safe and sound loans in the communities they serve. But nowhere does it tell them to make unaffordable, unsustainable loans that set people up for failure. Most of the subprime and high risk nontraditional mortgages were made by non-CRA lenders.

mythology that has emerged in the past three years (and has been stubbornly maintained) in defense of "the market" and since I consider adherence to it as a symptom of cognitive dissonance among the BLF it is worthwhile expending some effort to demonstrate its falsity. The following points are based mostly on a study by Federal Reserve staff (which to my knowledge has not been refuted by any scholar or other expert.) [See Board of Governors of the Federal Reserve System (2008)]

- Approximately 60 percent of "high-priced" (i.e., subprime and Alt-A) mortgage loans were made to middle-income and high-income borrowers or in middle- and high-income neighborhoods whose populations are *not* the targets of the CRA legislation.[22]

- More than 20 percent of high-priced loans made to low- and moderate-income borrowers or to borrowers in middle- and high-income neighborhoods were extended by nonbank institutions unaffiliated with depository institutions covered by the CRA.

- Approximately 17 percent of subprime and Alt-A loans to low-income borrowers were extended by institutions that fall under the CRA umbrella but were made in areas *outside* these institutions' "assessment areas" and thus did not contribute to their CRA performance evaluations.

- Only 6 percent of high-priced loans to low-income borrowers or in low-income neighborhoods by lending institutions that fall under the CRA legislation were made in their CRA assessments areas. (Board of Governors of the Federal Reserve System, p. 3)

As Kroszner says about the last point, "[t]his result undermines the assertion by critics of the potential role for the CRA in the subprime crisis. In other words, the very small share of all high-priced loan originations that can be reasonably attributed to the CRA makes it hard to imagine how this law could have contributed in any meaningful way to the current subprime crisis."

Federal Reserve staff also looked at the *performance* of "CRA-related" mortgage loans in terms of delinquency (payments overdue for 90 days or longer) and foreclosure rates. They compared delinquency rates on subprime and Alt-A mortgage loans in low-income and middle- and high-income areas and found high delinquency rates on all high-priced mortgages but there was little difference among areas based on income disparities. They also studied delinquency rates in areas with median incomes just above and just below the "CRA threshold" and found no measurable differences in delinquency rates. Finally, they looked at foreclosure rates by geographic areas based on income differences and found that the majority of foreclosures took place in middle- and high-income areas and were increasing faster in those areas than in low-income neighborhoods. All in all, the Fed study can be seen as clearly rejecting the notion that the CRA was a factor in the making of the financial crisis. It

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And these loans were made in large volumes because for a time they were highly profitable and because Wall Street would buy them and securitize them. It's as simple as that.

[22] Alt-A mortgages have been defined as follows: They "offer more lenient application requirements than conventional mortgages... it [sic] does not require applicants to provide full documentation for their income or assets. As the result, the Alt-A mortgages are open to borrowers who can't qualify for most traditional mortgages." (See *Financial Web* available at http://www.finweb.com)

concluded as follows: "[t]aken together, the available evidence to date does not lend support to the argument that the CRA is a root cause of the subprime crisis." (p. 6)

6.

In April 2010 I conducted an e-mail survey in which two groups of economists were asked about their views on the causes of the global economic and financial crisis. Group A consisted of the signers of an open letter sponsored by the Cato Institute and published in the *New York Times* and other major newspapers in the United States opposing President Obama's stimulus bill (ARRA).[23] The letter was signed by 256 economists, including at least one Bank of Sweden Nobel memorial prize winner. In the following weeks additional individuals signed the letter bringing the total to 335. It is clear, based on the contents of the letter and the character of the sponsor that the signers are self-proclaimed BLFs.[24] (The list of signers almost overlaps the list of economists who signed a newspaper advertisement supporting Senator McCain's economic policies over Obama's in the 2008 presidential election; only 40 individuals who were on the McCain list did not sign the Cato letter.) Group B consisted of a random sample of 1,527 members (i.e., approximately 10%) of the American Economics Association. There were 10 questions concerning factors that might have caused the crisis (which are given in the appendix). I chose the items based on views widely expressed both by economists and non-economists in the past two years on the possible causes of the crisis. For each factor respondents were asked what effect they thought it had on the crisis expressed on a scale from 1 to 10 (with 1 representing no impact and 10 representing a major impact). They were also asked to pick the top three factors they believed had the biggest impact on the making of the crisis. 115 individuals from group A responded to the survey (for a 34% response rate) and 259 individuals from group B (for a 17% response rate). The results of the survey are contained in the table below.[25]

The results are generally what one would expect when comparing a group of BLF economists to a randomly selected group of "other" economists. Note that the null hypothesis (no statistically significant difference between the responses of the two groups) is rejected at the 0.0001 level for almost all the items. The null hypothesis is accepted for item 6 ("Borrowing by households beyond their capacity to repay was a major cause of the financial crisis of 2007-2009."), i.e., the views of the two groups on this question are almost identical and for the "top 3 contributors" part of item 10.[26] Thus consider item 1 ["Misaligned incentives ('moral hazard') confronting executives and employees of mortgage-originating institutions were a major

[23] The letter can be accessed at http://www.cato.org/special/stimulus09/cato_stimulus.pdf The Institute describes itself as follows: The mission of the Cato Institute is to increase the understanding of public policies based on the principles of limited government, free markets, individual liberty, and peace.

[24] It is noteworthy that the argument made in the letter can be viewed as a *non sequitur*. The signers urge that "[t]o improve the economy, policymakers should focus on reforms that remove impediments to work, saving, investment and production. Lower tax rates and a reduction in the burden of government are the best ways of using fiscal policy to boost growth." The implication of this is that the severe cyclical downturn happened as a result of "impediments to work, saving, investment and production;" This presumably represents a new business cycle theory.

[25] The response rate for group A is comparable to that reported by others who conducted surveys of economists. The response rate for group B is on the low side. See Whaples (2009)

[26] Of course, statistical analysis must be interpreted with caution here. (i) It is unlikely that the "other" economists, i.e., "group B" does not contain some (many?) BLFs. (ii) The Cato letter signers are a self-selected group, and thus there may be some question whether they constitute a random sample of the "BLF population."

cause of the financial crisis of 2007-2009."] This goes to the basic question of whether the private sector or "government" was responsible for the crisis. As one would expect, the "Cato group" assign a lower weight to this factor than the "other" economists. Or consider item 7 ("Lack of transparency in the financial sector, 'off balance sheet entities' and similar policies were a major cause of the financial crisis of 2007-2009."] Again, accepting this factor as a major cause implies that the private sector is at least partly responsible for the crisis. It is therefore to be expected that the BLF group do not, on average, emphasize this factor and the difference between them and the AEA group is obvious to the naked eye. The same goes for five or six of the remaining items. All of these results can be viewed as interesting (and they seem to confirm the existence of the BLF as a distinct group among economists), but they do *not* demonstrate the presence of CD among the BLF. After all, reasonable scholars can (and do) differ about the role of most of these factors in causing the crisis. But I have demonstrated in section V that it is not reasonable to persist in the belief that the CRA wholly or partially caused the crisis and that persistence in such a belief can be viewed as a symptom of cognitive dissonance. Examination of the survey results

Views of the Economics Profession on the Global Financial Crisis—Survey Results						
	Mean Rating by Factor (Standard Deviation in Parentheses)			**Percent Rating Each Factor As a Top 3 Contributor**		
Question No.	**Cato**	**AEA**	**t score**	**Cato**	**AEA**	**z score**
1	7.47 (2.37)	8.41 (1.84)	-3.7778***	38%	48%	1.82*
2	9.11 (1.46)	6.98 (2.33)	10.7176***	85	25	–14.07***
3	6.33 (2.30)	8.25 (2.02)	-7.7262***	18	55	7.82***
4	5.77 (2.53)	8.11 (2.14)	-8.6405***	15	47	7.03***
5	6.10 (2.32)	7.91 (2.09)	-7.1732***	16	39	–3.63***
6	7.14 (2.45)	7.29 (2.16)	-0.5661	30	26	–0.79
7	5.48 (2.73)	7.30 (2.20)	-6.5754***	10	31	5.24***
8	6.88 (2.73)	5.83 (2.47)	3.5323***	46	12	–6.71***
9	7.85 (2.11)	5.00 (2.85)	10.7662***	37	13	¯4.84***
10	3.26 (2.38)	4.57 (2.38)	-4.9120**	3	5	0.96

* significant at 0.1 level
** significant at 0.001 level
*** significant at 0.0001 level

shows that (i) on average the "Cato signers" assign a higher rating to the CRA as a cause of the crisis than the AEA group (and this result is statistically significant at the 0.0001 level) and (ii) 46% of the Cato group believe that the CRA was among the top three factors that caused

the crisis compared to 12% of the AEA group (and the results are again statistically significant at the 0.0001 level). I believe this survey result provides strong support for the hypothesis that the BLF exhibit symptoms of cognitive dissonance in their response to the global financial crisis.

7.

In a book predating publication of *A Theory of Cognitive Dissonance*, Festinger and two co-authors published a study of a cult centered on woman from an American mid-Western city who claimed to have been in contact with beings from another planet from whom she received messages that the world would end in a great flood on December 21, 1954. (Festinger, Riecken and Schachter, 1956) People who gave up their earthly possessions and joined the cult would be saved by being transported to the other planet on a spaceship. Before the prophesied event members of the cult shunned publicity and did not proselytize. All that changed once the event was "disconfirmed." At least some members of the cult claimed that the catastrophe was averted due to their exemplary behavior and their sacrifices, and began proselytizing to attract new members. Festinger, Riecken and Schachter write the following (p. 3):

> Man's resourcefulness goes beyond simply protecting a belief. Suppose an individual believes something with his whole heart, suppose further that he has a commitment to this belief and that he has taken irrevocable actions because of it, finally, suppose that he is presented with evidence, unequivocal and undeniable evidence, that his belief is wrong: what will happen? The individual will frequently emerge, not only unshaken, but even more convinced of the truth of his beliefs than ever before. Indeed, he may even show new fervor for convincing and converting other people to his view.

Nevertheless, this enthusiastic phase lasted only a month or two. (see Epilogue) In the end disconfirmation led to the breakup of the group and its dispersal throughout the Unites States. Unfortunately, in economics there does not appear to be permanent disconfirmation. After all, the causes of the Great Depression are still (or again?) being debated. But perhaps we can attribute this to the complexity of economic and social life: any apparent disconfirmation of a prediction made by a theory can always be attributed to some "exogenous" factor. Hence I am unable to end on a note of optimism. Unlike Solow I cannot see the ideology of the BLF "fading away," especially since the market system seems to have survived once again, thanks perhaps to interventions which the BLF apparently despise.

Appendix—Survey Questions

Views of the Economics Profession on the Global Financial Crisis

Thank you for taking a moment to complete this brief survey. We are attempting to gauge the views of the economics profession on the causes of the global financial crisis.

1. Misaligned incentives ("moral hazard") confronting executives and employees of mortgage-originating institutions were a major cause of the financial crisis of 2007-2009.

2. The policies pursued by government-sponsored enterprises (GSEs), such as "Fannie" and "Freddie" were a major cause of the financial crisis of 2007-2009.

3. Excessive risk-taking ("overleveraging") by major financial institutions was a major cause of the financial crisis of 2007-2009.

4. "Regulatory failure" by the Fed and other regulatory agencies was a major cause of the financial crisis of 2007-2009.

5. The growth of complex derivative securities such as collateralized debt obligations (CDOs) and credit-default swaps (CDSs) was a major cause of the financial crisis of 2007-2009.

6. Borrowing by households beyond their capacity to repay was a major cause of the financial crisis of 2007-2009.

7. Lack of transparency in the financial sector, "off-balance sheet entities" and similar policies were a major cause of the financial crisis of 2007-2009.

8. The Community Reinvestment Act of 1977 (amended in 1995) was a major cause of the financial crisis of 2007-2009.

9. "Loose" monetary policy conducted by the fed and other central banks was a major cause of the financial crisis of 2007-2009.

10. A global "savings glut" which led to excessively low long-term interest rates was a major cause of the financial crisis of 2007-2009.

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