

Economists too need a code of ethics

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Geneva, 22 Nov (Kanaga Raja) -- There is need for a code of ethics for economists in light of the fact that in the vast majority of the time, academic financial economists have failed to identify their affiliations with private or public financial institutions and possible conflicts of interest when writing about or commenting on financial policy issues.

This is one of the main findings of a study by the Political Economy Research Institute (PERI) of the University of Massachusetts Amherst.

The study, in the form of a Working Paper titled "Financial Economists, Financial Interests and Dark Corners of the Meltdown: It's Time to set Ethical Standards for the Economics Profession", was authored by Gerald Epstein and Jessica Carrick-Hagenbarth.

According to the authors, their study analyses the conflict of interest that exists when academic financial economists, in their roles as presumed objective experts, while writing articles in newspapers, testifying in public panels, taking positions as advisors for politicians or when being interviewed by the media on topics such as financial regulation, fail to report their private financial affiliations.

Stressing that economics is unusual among the professions in that it does not have a code of ethics providing guidelines to navigate possible conflicts of interest, the authors said: "It seems apparent that a first step for economists is to create and adhere to a code of ethics."

In the context of their study, the authors underlined that the code of ethics would prescribe that economists list their private affiliations in any appearance for the media or the government when there is a conflict of interest or the appearance of a conflict of interest.

The authors said that they analysed the linkages between academia, private financial institutions and public institutions of nineteen academic financial economists who are members of two groups -- the Squam Lake Working Group

on Financial Regulation and the Pew Economic Policy Group Financial Reform Project -- who have put forth proposals on financial reform. The majority of these are prestigious academic financial economists.

In addition, the authors reviewed media writings and appearances, as well as the academic papers of these economists between 2005 and 2009, to determine the portion of the time these economists identified their affiliations with private or public financial institutions when writing about or commenting on financial policy issues.

According to the working paper, academic economists often occupy roles not only in academia itself, but also in both the general media and in politics. Often, they are looked to as experts in their fields.

"They write op-eds for newspapers, they testify on public panels, they take positions as advisors for politicians and they are interviewed by the media. Academic economists often convey the impression that they occupy these positions as independent objective experts."

"At the same time, some academic financial economists also consult for, serve on the boards of and even own private financial institutions. When economists serve a role as an objective expert for the media as well as a role with the private sector, there is a conflict of interest. Their objectivity may be compromised by their work in the private sector or, at least, raise questions about the possibility of bias. In this case, those relying on academic economists' assessments to help them make judgements about economic or policy issues deserve to know that such a potential bias exists," the paper adds.

The paper stresses that the issue has a great deal of salience, as the debate over financial reform has taken centre stage and many prominent academic economists have been called on to discuss and even formally testify before Congress on financial legislation.

The authors noted that the question of financial economists' potential conflicts of interest arises in the context of the role economists have played in the run-up to the financial crisis of 2007-2010.

"One widely discussed issue has been this: why did the vast majority of economists fail to foresee the financial crisis despite numerous signs all around them?"

There are several prominent explanations, the paper points out. One is that economists depended too much on abstract models that do not allow for bubbles and crisis. Another is that they were blinded by ideology. A third possibility is that economists faced a conflict of interest. In this third scenario, academic

financial economists, like so many others, had perverse incentives not to recognize the crisis.

There is a well documented relationship between Wall Street, the White House and the government. Some prominent examples have received wide-spread attention: Timothy Geithner, the current Treasury Secretary, has several counsellors that were receiving millions of dollars each year from Wall Street firms, such as Goldman Sachs Group Inc. and Citigroup Inc. among others, the paper notes.

Two of these aides are Lee Sachs and Gene Sperling. Lee Sachs received \$3 million in salary pay as well as partnership income while working for the Mariner Investment Group. Gene Sperling made \$887,727 in 2008 from Goldman Sachs as well as \$158,000 in speaking fees, primarily coming from financial companies. Both Sachs and Sperling receive \$162,900 from their job as aides for the Treasury.

The authors also noted that another member close to US President Barack Obama is Lawrence Summers, the Director of the White House's National Economic Council. Summers (who has since left his post) has been found to have received around \$5.2 million during 2008-2009 from the hedge fund D. E. Shaw, as well as, additional money from other major financial firms, mostly in speaker's fees.

"The academic financial economist faces a conflict of interest when s/he has private financial affiliations and also serves in the media as a public expert," says the paper, adding that although the conflict of interest between the business economist who serves public positions has been written about widely, that of the academic financial economist has received little attention.

The authors found that academic financial economists are not disclosing these potential conflicts of interest either publicly or academically.

"Moreover, these conflicts of interest could have potentially hindered the identification of the housing bubble and can potentially hinder the formation of a strong proposal for financial reform", they said.

They added however that they did not present evidence here in support of these effects which they suggested should be the subject of future research.

The authors also stressed that the study is not based on a random sample of financial economists, and that it only deals with a small subsection of financial academic economists and is therefore only suggestive of a broader problem.

In order to evaluate the extent of the affiliations between the financial academic economists and the private sector, the authors said that they began with two groups of economists that were prominent in the field of financial economics and which had taken a public stance on financial regulation, the Squam Lake Group and the PEW project on Financial Reform.

Their findings are that of the nineteen economists that the authors included in their study, thirteen, or almost 70%, worked in some capacity with private financial institutions. In the sample, two of the financial academic economists are co-founders of private financial services firms where they work in key positions, one as managing partner and the other as chief economist. A third economist works for two banks, in one case, as president and in the other, as director. Eight of the financial academic economists serve on the board of directors of private financial firms and two economists were identified as consultants or affiliated experts for private financial firms.

"The fact that well over half the economists we evaluated have positions with private financial firms shows how commonplace it is. The question arises: how often and in what contexts do these financial economists reveal their connections to these private firms?" the authors asked.

On how the economists identified themselves in their writings, the authors said that they reviewed both general media and academic publications, evaluating how the economists identified themselves in both domains.

With regards to how the economists identified themselves in their academic publications, the paper finds that the most common identification was with their academic position, labeled professor, and inclusion as a member of NBER (National Bureau for Economic Research), and occasionally by prestigious appointments in public and international institutions.

On the proportion of times these economists identified their private financial affiliations in their academic papers, the study finds that these economists rarely identified themselves as working in the private sphere.

On the percentage of media articles in which the economists cite themselves as having affiliations with private financial institutions, the paper again finds that economists most often identify themselves with their academic position and rarely with their roles in private financial institutions. This occurs even when they are proposing policies concerning the regulation of financial markets.

In the case of media articles, the authors found that most of the economists did not identify themselves with the private financial institutions they had affiliations with. Of the thirteen economists with ties to the private financial world, eight of

them did not acknowledge these ties in any of the general media articles reviewed.

"This means that a very significant portion of the economists did not recognize any affiliation or possible conflicts of interest when identifying themselves in the general media. The remaining four that did recognize an affiliation did so to differing degrees," says the paper.

It notes: "It is reasonable to think that the media bears some responsibility here and should inquire as to whether the economist has private affiliations when interviewing him or her. But, rarely did the media take on the role of identifying these economists with their private financial institutions in order to qualify or alert readers to conflicts of interest. Thus, if the economists do not take on this ethical imperative, there is little chance the media will take it up either."

The authors said that they also explored what quantitative effects these conflicts of interest may have on the strength of the calls for regulation by these economists. They found that it was very difficult to make a quantitative argument. There seems to be little difference between those with private financial affiliation and those without.

The paper underscores that there are many reasons why this could be the case. First, there may be a similar overarching ideology prevalent in economics concerning the virtues of the free market that the majority of mainstream economists ascribe to. Second, it could be that central banks, governments and international institutions prefer to employ economists with a similar outlook on regulation as those chosen by private institutions. Third, there is the possibility that the lines between academic financial economists and private financial affiliations may be much more fluid than was captured due to the difficulties of locating consultancies.

"We hoped to answer the question of whether these economists' positions with private financial institutions affect the extent of their calls for financial reform. We conjectured that the stronger the economists' alliance with the private sector the weaker would be their calls for regulation. A problem we encountered was the little variation on financial reform calls among the economists in our study. This is indicated by the range of only 0-33% [the range of opinions as measured by the authors' Financial Reform Index] ...," the authors said.

They added: "Moreover, the small size of our sample renders impossible any rigorous test of this hypothesis. In any case, it is difficult from our data to tell if there is a significant difference in the extent of regulation called for between those with links to private financial institutions and those without."

The authors further highlighted that the economists included in the study not only have connections to private financial firms, they are also connected to public entities and international organizations. Many of the economists work for central banks both within and outside of the US, for international institutions, such as the International Monetary Fund (IMF) and the World Bank, as well as occupying government positions in the US and abroad.

"In recent years, these institutions have, for the most part, promoted widespread financial de-regulation."

On the economists and what kinds of public positions they hold categorized by central banks, international institutions and government positions, the paper finds that a significant portion, eight of nineteen (42%) of the economists the authors looked at, currently hold positions or have held positions in such entities over the period 2006 to 2009.

During that period, six economists have been or are currently working with the Federal Reserve, two have been or are currently working with international institutions and one has been or is currently working in a government position.

"This number increases substantially if we include the total past history of the economists in our study. In this case, we find that fourteen of the nineteen (74%) economists have at some point held a position in one of these entities," the authors said.

"Although this is not the main focus of our paper, it is useful to recognize that public sector, government and positions in international institutions could cause a similar bias as that which we found with regards to the private financial institutions. If this is true, then it may be ethically necessary to disclose these positions as well as those in private financial firms," they added.

The authors further found that the academic financial economists in the study often hold positions in the private sphere, for public entities, or for international organizations; and occasionally they work in a combination of these.

"We find that many of these economists hold more than one job. While holding a prestigious academic job, they may also work in the private financial sector, with public entities or international organizations... It is plain that the purely academic financial economist in our survey is a rare species indeed."

The paper also addresses the impact of the recent financial crisis, saying that the crisis is a clear indicator of problems existent in the financial sector. These problems were not recognized by much of the economics profession prior to the financial crisis.

Many mainstream academic financial economists did not question the increasing leverage and underlying insecurity of the financial sector, relying instead on the institutions and practices of the New Financial Architecture (NFA), which integrates minimal regulation with complex financial instruments and government bailouts, assuming that unhindered capital markets correctly price securities and distribute risk to those best able to handle it, minimizing that risk in financial markets.

"The recent turmoil exposed the many fallacies of the NFA, including the instability of new and complex financial instruments that achieved a prominent role in the financial infrastructure, as well as the instability caused by the progressive dismantling of financial regulation over the past thirty to forty years," said the authors.

The authors also assessed whether the economists they reviewed changed their minds before and after the crisis with respect to financial reform. Of the nineteen economists they evaluated, nine have changed their opinions with regards to financial reform after the financial crisis. This is almost half of the economists in the study. If one excludes the four economists whose views could not be evaluated, then 9 out of 15, or 60% changed their minds on regulation after the crisis.

As to whether this is a lot or only a little, the authors noted: "In view of the severity of the crisis and the role of financial regulation (or the lack thereof in precipitating it), 60% seems remarkably low to us."

The authors stressed that economics is unusual among the professions in that it does not have a code of ethics providing guidelines to navigate possible conflicts of interest.

"It seems apparent that a first step for economists is to create and adhere to a code of ethics," they said, adding that in the context of this paper, the code of ethics would prescribe that economists list their private affiliations in any appearance for the media or the government when there is a conflict of interest or the appearance of a conflict of interest.

For example, they suggested, if an economist were to write an op-ed, they should describe themselves not only as a professor but also as a board member, an owner and/or a consultant. These roles should also be reported when testifying in government positions or being interviewed by the media.

"In this study, we showed that the great majority of two groups of prominent academic financial economists did not disclose their private financial affiliation even when writing pieces on financial reform. This presents a potential conflict of interest. If this pattern prevailed among academic financial economists more

broadly, this, in our view, would represent an even greater social problem," the authors cautioned. +