Response to "Neil Fligstein Answers Questions on the Present Financial Crisis"

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The questions put to Dr. Fligstein in the November issue of the journal are critical, in fact very critical, and appropriate. Economists not only missed the current recession but actually the last half dozen major direction changes in the world's economy, not to mention several dozen more local economic crises and upsets. What do they do to earn their salaries? But economic sociologists fared no better. This is an interesting result particularly in light of the heavy criticism economic sociologists have leveled at economists and economics over the last dozen years or so. Dr. Fligstein really never provides specific reasons for economic sociology's failure though the interviewer puts this question to him. He merely notes that, "…economic sociologists did no better at understanding how the American financial sector was building itself up to the current crisis than the economists. I include myself in this regard. This should give us great pause." Indeed it should give economic sociologists pause, and perhaps a chance to "re-think" their discipline.

However, Dr. Fligstein is incorrect that the crisis was not predicted. It was in fact predicted. Studying this prediction will I believe help economic sociologists (and economists, though most will never admit it) figure out "how they missed it" and what they should do next.

On September 7, 2006 (yes, 2006) Nouriel Roubini, a relatively obscure economics professor at New York University announced before an audience of some of the most respected economists in the world at an International Monetary Fund (yes, the I.M.F.) meeting that a financial crisis was brewing and would soon break across the world. There would be within a year a once-in-a-lifetime housing bust, an oil shock, sharply declining consumer confidence, and ultimately a deep recession. He described a world of thousands of mortgage defaults, trillions of dollars lost in mortgage-backed securities, and the global financial system nearly grinding to a halt. Many hedge funds would be crippled if not destroyed, along with investment banks and other major financial institutions like Fannie Mae and Freddie Mac. Needless to say his remarks were met with disbelief, not a few sneers, and several objections to his even being invited to speak. The world economy at the time was not at the top of its game but it was doing well in historical terms and seemed poised to do even better.

How was Roubini able to make this prediction? Was he just lucky, shooting in the dark, or did he know something others did not? By all accounts Roubini is generally a dour person, pessimistic in most circumstances about the economy of the US and the world's economies. These accounts seem accurate enough. However, after speaking with Roubini several other things became clear to me. He does not look at himself as a pessimist but rather a pragmatist, in his words a "realist" who continually searches for and assesses potential risks and vulnerabilities that most others don't look for. He sees himself as "the clear-eyed outsider – unsettling complacency and puncturing pieties."

Several elements in his life story shape this probing pragmatism. Roubini has always been an outsider. Born in Istanbul, the child of Iranian Jews, his family moved to Tehran when he was 2, then to Tel Aviv and finally to Italy, where he grew up and attended college. Then it was a move to the US to pursue his doctorate in international economics at Harvard. Along the way he became fluent in Farsi, Hebrew, Italian and English. His own description of his life is as a "global nomad." At Harvard he displayed an unusual skill set, he was just as comfortable with the arcane mathematics of economics as he was with investigating economic and political institutions. After Harvard he began teaching at Yale and there met and worked with Robert Shiller, the economist who would provide prescient warnings about the 1990s tech bubble crash. Throughout the 1990s Roubini studied the various financial crises that were occurring around the world from China to Argentina, from Brazil to Russia. He noted similarities in the crises. In each instance the country had a large current-account deficit (meaning, basically, the country spent far more than it took in), and these deficits were typically financed by borrowing from abroad in ways that exposed the country to the national equivalent of bank runs. Most of these countries also had poorly regulated banking systems plagued by excessive borrowing and reckless lending and investing. Corporate governance was often weak, with noticeable cronyism. The similarities to the situation in the US in the mid-2000s are obvious. By 2004 Roubini had reached the conclusion that the US was next up for crisis. But the US was not an emerging economy, like China or Brazil. It was the largest economy in the world. It was the customer of last resort for all other economies. Any crisis in the US would not only be larger but would have worldwide consequences and could begin a world recession. With these concerns in mind Roubini began writing and speaking about this upcoming mammoth crisis about to strike.

Roubini's predictions have been criticized from a variety of perspectives. Some call him just a pessimist who was correct, by accident, a couple of times. Anirvan Banerji, the economist who challenged Roubini's first I.M.F. talk, points out that Roubini has been peddling pessimism for years; Banerji contends that Roubini's apparent foresight is nothing more than an unhappy coincidence of events. "Even a stopped clock is right twice a day," Other critique his methodology in arriving at these predictions, calling it "subjective," and out of line with the rigorous quantitative modeling requirements of the economics profession. Many disparage it as analysis by analogy, subject to as many wrong as right guesses, and, more importantly, allowing the economist to assess the world before her/him rather that leaving analysis to analytic (read mathematical) models that spit out so called "objective facts." Roubini feels the need to defend himself from such accusations, noting that he remains a rigorous scholarly economist, whose primary commitment is to the tight analytic models of his discipline. However, Roubini's approach to arriving at the predictions he made at the I.M.F. meeting in 2006 have much to teach both economists and sociologists about understanding and describing markets and other economic actions and actors. In fact, it's my view that these, not the rigorous analytic models of economics or the less analytic and quantitative but no less influential models used by sociologists that should be primary in our attempts to describe and understand economic actions and actors of every sort.

In the social as process actors (of every sort) are continually re-designing the world in which they live. This certainly includes financial actors and the economic arrangements (markets and otherwise) in which they are involved and the devices used for that involvement. Some of this work is subtle and has little overall impact but other work changes large parts of the world. I suggest to you that during the period from 1980 through 2008 a massive re-design of financial markets occurred, and continues today. This re-design was in fact so broad and so deep that just about every other sort of market, economic arrangement, and economic device was modified, often so much so as to be virtually unrecognizable from the perspective of markets, arrangements, and devices that existed just a few years, in some instances just a year or less before. The goals pursued through these arrangements and devices did not change – find the greatest return for money invested and manage the risks to ensuring the highest return possible. But the institutions and devices for that pursuit changed rapidly up till 2008, slowed down during most of 2008, but are now beginning to gain momentum once again.

I make these points to show how Roubini's approach allowed him to predict the economic crisis when other economists did not and why sociologists shared this failure. Roubini's method is one that his fellow economists would label nontechnical and subjective. Roubini made extensive use of transnational comparisons and historical analogies. He did not build a model in order to constrain his subjective impressions and abide by a discrete set of data, the scholarly ideal in economics. In a like manner to Keynes, Roubini surveys vast quantities of economic data over a broad spectrum of topics, looking for clues to what's happening and why. And while he does not completely ignore economic models, quantitative and qualitative, these do not control what he examines or how he makes his examinations. It's my view that the appropriate role for models is as a starting point for research. But no model does, or could ever capture the world in "real-time." Before the economist or sociologist has finished writing up the model and publishing it for all to see and review, the world the model "represents" has been changed by the other actors involved in that world. I'm not suggesting that models be abandoned. If comprehensive and accurate, they provide valuable historical insights into the actors, arrangements, and devices that at one point in time made up a world. But if you really want to describe for others the world that exists today, or at least last week, the only models that matter are those the actors, all the actors in that world have built and the arrangements and devices with which they have populated that world. The models constructed by economists and sociologists are, at best, mere partial and incomplete reflections of what actors have built. Their best chance of depicting accurately and fully what actors have built is to be as closely connected in time and distance to the actual construction work as possible. The notion that transcendent models can be constructed that set out the "basic operating principles" of actors' construction work that can be applied in virtually all situations is a fanciful falsehood that economists and sociologists find comforting. It seems to provide them a level of understanding and thus control not available to the other actors. But what models really engender in both economists and sociologists is a false sense of comfort, complacency, and familiarity. Models hide more than they reveal, deceive more than reveal the facts. No actor, human or otherwise controls any construction process. This includes sociologists and economists. But actors in networks are what make the world go round.

Through chance or predilection, Roubini has selected what is really the only practicable and workable approach for sociologists and economists in seeking to describe and understand the worlds that actors build. Roubini examines all aspects of a world and the work that went into building it. But more than that, he looks for risks and vulnerabilities in that world and he expects to find them. And well he should. The process of constructing arrangements and devices is always risky, uncertain, unfinished, and subject to failure often and along many fronts. So even if actors set out to construct a firm and predictable world, they cannot. They simply do not have that level or expanse of control over final results. Also, Roubini does not assume that some sort of "economic laws or forces" will provide the final explanation and settle all outstanding questions. He seems to recognize and accept that such laws or forces do not exist. Applying this to sociology, sociologists must disabuse themselves of the notion that the "social" provides an explanation for the actions and work of actors. It does not. In fact, the social, as a "thing or force" that explains actor actions simply does not exist. Social is a process, a process of putting together all sorts of disparate actors, tools, texts, rules, equations, etc. to construct a world that lasts for a time (short or long) but is never permanent or fixed. And this process is difficult, time consuming, and very hard work. That's why it often fails and frequently doesn't function as anticipated. No world or its contents is outside this process. And that includes the world of science and those parts of a world called facts.

Like economists sociologists are optimists. They believe that ultimately the world is explainable and can be modeled and predicted (perhaps less so for sociologists). And they believe that "economic" and "social" scientists are the stewards of the methods and theories that will make such modeling and prediction possible, and thus improve human existence. But unfortunately economists and sociologists are also simplistic in their views of the world they set out to model and predict. Moreover, they run away from the complexity of these worlds or hide it under such "technical" terms as "supply and demand," "efficient markets," "social institutions," and "socioeconomic status." These are worse than useless because they often stop anyone looking at what's actually going on. Here too Roubini gives us valuable direction. He is not an optimist.

So after all this why did both economists and sociologists (so called economic sociologists) fail to predict the recession in which we find ourselves mired today? Simply put they failed because they did not see it coming. Or, more accurately, they *could not* see it coming. Their attention was on analytic models, as they had been taught in graduate school and on the methods to apply and expand these models. But the actors and arrangements these models supposedly described had moved on. They continued to build and re-build (which is quite normal) and soon were taking actions and setting up arrangements that simply did not exist in the models. The models could not predict what was not included in them. And even if some economists or sociologists had managed to put the models more "in sync" with current actors, actions, and arrangements it's still unlikely the models would have predicted the crisis. After all they're just models, a simplistic summary of what actors have constructed. So inside the models actions and arrangements could be predicted and explained. Trouble is, the world of the model was not the world of the actors actually inventing, packing, selling, and buying credit default swaps or thinking up new ways to make mortgage loans they were almost certain could not be repaid. Actors are creative, models are not. So models will almost always be wrong. And when actors are particularly creative, as they were in financial markets between 1980 and 2008, and even today, actors' creativity will always leave models behind, often quite quickly. So long as the attention of sociologists and economists is focused primarily on models rather than the creative construction work of actors there is virtually no chance they would notice the end of civilization, let alone the largest recession since the Great Depression.

Fligstein asserts that "Almost no one in sociology really caught up to how the financial sector (defined by the industry categories 'finance, insurance, real estate') in the U.S. increased its share of overall corporate profits in the country to about 40% with 7% of the labor force and 10% of GDP...". I concur. But when questioned about how to avoid such failures in the future Fligstein asserts that the conceptual tools used in *Transformation of Corpo-*

rate Control and the *Architecture of Markets* remain relevant. Here I do not concur. He fleshes this out by concluding "My view of how to study markets focuses on how firms organize particular industries, construct conceptions of control (i.e. ways to make profits and stabilize their relationships to their main competitors), and how this occurs in relation to governments." This is a wonderful example of why he and most other "economic sociologists" missed the current recession. They, like he, assumed they knew the contents and contours of firms, markets, profit, finance, etc. They assumed their books and models had captured these. But they had not, could not.

While sociologists busied themselves with tweaking and applying their models, actors involved in finance were busy turning all the models on their heads. If more attention had been on the work of these actors and less on the models of sociologists not only the contours and contents of a "new economic world" would be noted but also the risks, dangers, and uncertainties of that new world. The dominating financial markets operate in almost exact reverse of the two major themes of Fligstein's model in *The Architecture of Markets* – that markets and companies move toward stabilization and that market-building and state-building go hand-in-hand. In fact movement away from Fligstein's model had been going on for at least 20 years. While Fligstein's efforts in *The Transformation of Corporate Control* are to be admired they still do not fit recent and current financial corporations. He is correct that large corporations' form and operations have been re-designed and re-built over the last 100 years in the interaction of various involved actors, including corporate officers, government regulators and legislators, laws, accounting standards, quantitative devices, and neo-liberal economics. He is correct also that in some instances this re-design and re-building did not meet the requirements of neo-liberal economics – profit maximizing firms blindly competing with one another to become the most efficient and thus most profitable. His view is that firms always take a more moderate path, if available, in order to survive and grow. That is, firms compromise maximum profits in favor of "reasonable" profits and growth along with greater safety. But virtually none of this applies to financial firms of the last 25 years. In a great many instances, especially with the largest of these firms, they are indeed blindly seeking the absolute maximum profits and have no interest in compromising with either the government or other firms in this pursuit. Two goals guide the pursuit of maximum profit – creating new tools to meet this end (e.g., credit default swaps, subprime mortgages) and stopping other firms and government regulators from finding out the details of what's going on, by whatever means are available. This is a more "savage" view of markets and firms that I think Fligstein is comfortable with. He might even consider it a dysfunctional structure. But neo-liberal economists and many government regulators (e.g., Alan Greenspan) do not.

"Following the actors" is more time consuming and considerably more difficult to do correctly than constructing models to explain actor actions. Following the actors means the sociologist and economist must actually accept as real the world the actors construct and must assume the actors, not the economist or sociologist actually is the original builder of the world and what it means. In simple terms sociological and economic models are put in their proper perspective, as at best secondary and derivative of the world observed actors are and have constructed. This "pragmatic turn" does not ensure that the actors' world will always be properly understood or described by the sociologist and economist. But it does improve the odds of this being the result because it shifts the gaze of the sociologist and economist to the ongoing, ephemeral, and fragile construction work done by actors and to the potential risks and uncertainties of that work and its results. And at the same time it deemphasizes sociological and economic models of the world that actors have made. This is the best way to improve the chances that economists and sociologists will not miss the next big economic event, crisis or otherwise.

I close with two examples, one general and the other more specific. I set out these examples not to emphasize the deficiencies of sociology so much as to show that commitment to precisely describing[1] actors' worlds should be of paramount importance. The director of the upcoming movie *The Messenger*, Oren Moverman, emphasized in a recent interview the need to respect the "real world" actors portrayed in the movie enough to "get it right." In other words it's important to him that he accurately grasps the worlds these actors have made and present them accurately on the movie screen. In Moverman's words, "But you do have a responsibility to show things as they are."[2]

In the investigation of scientists and science reported by Bruno Latour in his books *Laboratory Life* and *Science in Action*[3] his investigation is not based on listening to what philosophers say about Truth, nor what sociologists say about Society, and not to what scientists say about Nature. Instead the investigation observes scientists at work. The focus: find out what they do, and not what they say. The results of the work are both instructive and at times quite surprising.

Sociologists should have this same primary focus. But unfortunately they do not. In this regard it is interesting to note the reports now coming from a group of Federal bank regulators doing "post mortems" on some of the about 2,000 banks that have failed over the last two years or so. The reports (called "material loss reports") from these "bank coroners" are quite clear in what they see as the reasons for the death of most of these banks. In almost every instance the "cause of death" was gross mismanagement and regulatory lapses. Two conclusions in the reports are most striking:

- State and federal regulators knew lenders were engaging in hazardous business practices but failed to act until it was too late.

- The financial overseers failed to act quickly and forcefully to rein in runaway banks.

So bank regulators at both the state and federal levels were aware many banks were heavily involved in hazardous lending, taking risks they could not afford but the regulators did not act. Based on the reports it appears this knowledge was in no way secret. So how did economists and sociologists miss it? It's hard to miss an 800 pound gorilla in the elevator, but it's easy when your model says you're in a stairway, or maybe an airport runway; or the gorilla is a fuzzy toy monkey.

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Endnotes

1 *Description is a pragmatic pursuit. Mostly I want to prompt sociologists to accurately translate the worlds actors have made, so that the actors and their worlds, not the sociologist or sociological models show through most clearly.*

2 *New York Times Movies. November 16, 2009.*

3 *Latour, Bruno, Steve Woolgar, and Jonas Salk (1986). Laboratory Life. Princeton, NH, Princeton University Press.*

Latour, Bruno (1988). Science in Action: How to Follow Scientists and Engineers through Society. Cambridge, Mass., Harvard University Press.