Richard A. Posner: A Failure of Capitalism: The Crises of '08 and

the Descent into Depression Harvard University Press, 2009

"Some conservatives believe that depression is the result of unwise government policies. I believe it is a market failure." Xii

"We are learning… that we need a more active and intelligent government to keep our model of a capitalist economy from running off the rails. The movement to deregulate the financial industry went too far by exaggerating the resilience – the self-sustaining power – of laissez-faire capitalism." Xii

"the disappointing performance of the economic profession in regard to anticipating and providing guidance in responding to the depression."

"The current economic emergency is… the outgrowth of the bursting of an investment bubble. The bubble started in housing but eventually engulfed the financial industry." P.13

"Low interest rates, aggressive and imaginative marketing of home mortgages, auto loans, and credit cards, diminishing regulation of the banking industry, and perhaps the rise of speculative culture – an increased appetite for risk… spurred speculative lending…" p.13

"There isn't much difference any more even between a commercial bank and a hedge fund." P.19

2005 article by Raghuram Rajan on the asymmetric response of investors to good and bad news from investment funds: "As Rajan pointed out, banks and other financial companies have little incentive, in deciding how much risk to take, to worry about small probabilities of disaster." P.27

Paulson made the mistake of thinking the banking problem was illiquidity, not insolvency.

"One reason that hedge funds have not encountered problems of insolvency as acute as those of commercial banks may be that no part of their capital is federally insured…" p.46

"Risky lending… brought on the Great Depression without benefit of securitized debt." P.53

"A neglected downside of distributing risk… is that it spreads risk to what would otherwise be safe markets." P.55

"Ordinarily one would expect a credit crunch to be self-correcting." P.62

“Government officials thought at first that the credit crunch was the result of a kind of panic – that the banks were scared to lend because they didn’t know how thick their liquidity cushion was.” P.63

“Fear of insolvency rather than fear of the unknown was the basic reason that banks were unwilling to lend.” P.68

“The immediate causes of the depression were the confluence of risky lending with inadequate personal savings.” P.75

“There were plenty of warnings of a housing bubble, beginning in 2003, warnings about excessive leverage in financial firms and even rather precise predictions of the debacle that has excused, as in ‘When Bubbles Burst…’ by Thomas Helbing and Marco Terrones published in October 2003.” P.77

Robert Shiller and Avinash Persaud warned in April 2004 and The Economist warned of the housing bubble in September 2002.

“We need to consider intra-firm conflicts of interest… risk managers vs. traders”

“Risk management, unlike trading, is generally not treated as a profit center in a firm… Hence a financial firm will tend to give more weight to the views of successful traders than to those of risk managers.” P.80

“With the rapid expansion of the financial sector in the early 2000s, young inexperienced traders and analysts achieved positions of responsibility in banks before they were fully prepared by training and experience.” P.80

“Problems of communication and control are endemic to organizations, especially large ones, and played a role in the crisis.” P.81

“The emergence of the organization problems… coincided with the creation of the new financial instruments.” P.81

“A choice under profound uncertainty is not adding a column of numbers but firing a shot in the dark…” p.83

He defends the rationality assumption and argues, “the current depression can be explained without hypothesizing irrationality, though not without assuming a certain amount or randomness… bubbles tend to be rational responses to uncertainty about the possible effects of major innovation.” P.85

“The housing and credit bubbles of the 2000s were a response to what seemed a new era in finance as a result of the widespread securitization of debt and a global capital surplus that was expected to keep interest rates low indefinitely…” p.86

“In each era the bubble began as a sensible bet on a bright though uncertain future; it continued to expand, even as fears began to be voiced that it might be a bubble… and it burst when the market realized that the expectation of a new era had once again been mistaken (or perhaps perceived prematurely). At no stage need irrationality be posited to explain what happened." pp.86-87

"…Before the fall the existence of a bubble could only be suspected, not confirmed." P.90

"Board members have a conflict of interest when it comes to setting executive compensation." P.99

"Before the financial crisis, much of the economic literature on executive compensation argued that corporate executive should be pushed to take more risks than they would like to." P.97

"Notice that I have listed no psychological factors among the underlying causes of the depression." P.100

"It was the failure… to heed warning signs and thus search out the necessary data, rather than a failure of model design, that caused the failure of prediction." P.111

"The economists who inspired the deregulation movement were not macroeconomists and did not differentiate between banking and other regulated industries such as railroads and airlines." P.115

He makes an analogy to pollution.

"Macroeconomists… thought that the problem of depression had been solved." P.115

"Real estate bubbles are common." P.118 The general media started talking about bubbles in 2004 "the financial journals… had been far ahead." P.119

"But the financial crisis when it finally struck the nation full-blown in September 2008 surprised the government, the financial community, the economics profession, and the public, even though it had been building for three years." P.120

The Fed started worrying a little about housing prices in 2006.

He argues that the literature on surprise attacks helps us understand "the blindness of experts to warning signs." P.122 These include prior beliefs.

"The cost and difficulty of taking effective defensive measures against an uncertain danger, and the absence of a mechanism for aggregating, and analyzing warning information flowing in from many sources and for pushing it up to the decision-making level of government."

The warnings by economists, journalists, and the BIS in June 2007 "made little impression on government officials, the stock market, or the public at large." P.124

LTCM overestimated its diversification of risks.

"An interrelated system of financial intermediaries is inherently unstable." P.128

He discusses chaos theory. May 2007, Bernanke “We see no serious broader spillover to banks or thrift institutions from the problems in the subprime market.” P.132

“In October, Bernanke and Paulson were still insisting that the banking industry’s problem was illiquidity, not insolvency.” p.133

He blames much of the slowness to see the problems on “the ideology of free markets, which teaches that competitive markets are on the whole self-correcting.” P.134-35

Second to ideology was that actions would be costly. P.136

“it is very difficult to receive praise, and indeed to avoid criticism, for preventing a bad thing from happening unless the probability of its happening is known.” P.138

“virtually all warnings are premature, because the date of a warned-against event is likely to be irreducibly uncertain.” P.138

The occurrence during the election cycle also delayed effective responses.

“Little bits of knowledge about the shakiness of the US and global financial systems were widely dispersed…” p.143

“Premature short-sellers lose big…” p.147

“ ‘Due process’ is a vague concept” p.210

“A depression is a learning experience… History suggests, however, that such lessons are quickly forgotten.” P.227-28

He calls for a closer integration of finance and macroeconomics. “In financial regulation the line between government and private sector is blurred.” P.238

“Conservatives like to beat up on Fannie Mae and Freddie Mac… [but] Their behavior mirrored that of the banking industry as a whole…” p.241

“There is a lack of convincing evidence that [the Community Reinvestment Act of 1977, and amendments made to it in the 1990s] were responsible for a substantial amount of the risky lending made during the housing bubble.” P.242

“The critical role of government in the crisis was one of permission rather than encouragement.” P.242

“Economic understanding of the causes and cures of depression has not progressed to the point at which ideology no longer influences analysis.” P.266

“Economists are influenced by ideology, but they are not impervious to evidence.” P.267

The about face to use TARP money for the auto industry “undermined Bernanke’s and Paulson’s claim that they lacked the legal authority to bail out Lehman.” P.277

“The successive Federal Reserve chairmanship of Greenspan and Bernanke must be reckoned prime causes of the financial crisis and the slide into depression.” P.281

He argues that “although the financiers bear the primary responsibility for the depression, I do not think they can be blamed for it – implying more censure – anymore than one can blame a lion for eating a zebra. Capitalism is Darwinism.” P.284

What Bernanke and Greenspan and the academy can be blamed for is its overconfidence in their understanding of how to prevent a depression and, as a result, a failure to attend to warning signs and a lack of preparedness.” P.286

He criticizes Lucas for saying that the central problem of depression prevention has been solved.

“There were three big prevention failures… excessive deregulation, neglect of warning signs, and insouciance about the decline in the rate of personal savings and the safety of such savings.” P.287

He distinguishes between changes in the regulatory framework and regime. “As far as I know, no one has a clear sense of the social value of our deregulated financial industry.” P.295

“Efforts to place legal limits on compensation are bound to fail, or be defeated by loopholes.” P.297

“let us hope that economists respond to the crisis in the spirit of pragmatism, rather than of ideology.” P.313

“It is important not to confuse making mistakes with being stupid.” P.321-22